1972

Unofficial answers to the Uniform certified public accountants examination, May 1969 to November 1971

American Institute of Certified Public Accountants. Board of Examiners

UNOFFICIAL ANSWERS

.....TO THE UNIFORM CERTIFIED PUBLIC ACCOUNTANT EXAMINATION

MAY 1969 TO NOVEMBER 1971

UNOFFICIAL ANSWERS

To the Uniform Certified

Public Accountant Examinations of

the American Institute of Certified Public Accountants

MAY 1969 to NOVEMBER 1971

By Daniel L. Sweeney and H. S. Hendrickson

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FOREWORD

The texts of the Uniform Certified Public Accountant Examinations, prepared by the Board of Examiners of the American Institute of Certified Public Accountants and adopted by the examining boards of the 50 states, the District of Columbia, Puerto Rico, Guam, and the Virgin Islands, are periodically published in book form. Unofficial answers to these examinations appear twice a year as a supplement to *The Journal of Accountancy*. These books have been used in accounting courses in schools throughout the country and have proved valuable to candidates for the CPA certificate.

Responding to a continuing demand, we now present a book of answers covering the period from May 1969 to November 1971. The problems and questions of this period appear in a separate volume which is being published simultaneously. It cannot be too strongly emphasized that these answers are not in any sense official. They represent merely the opinion of Daniel L. Sweeney, Director of Examinations; William C. Bruschi, former Director of Examinations; Harvey S. Hendrickson, Assistant Director of Examinations; J. T. Ball, former Assistant Director of Examinations; Park E. Leathers, Manager of Special Projects; and Howard P. Sanders and Doyle Z. Williams, former Managers of Special Projects, who prepared them for publication with the assistance of William A. Godla, Maria J. Salvemini, and Arthur D. Schwarz.

Guy W. Trump, *Vice President-Education*
American Institute of Certified Public Accountants

April 1972

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Solutions and Answers to Examination May 1969

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Solution 2

a. 1.

Argo Sales Corporation
BALANCE SHEET
December 31, 1968

Current Assets:				
Cash	$ 20,000	(6)		
Marketable securities	80,000	(7)		
Accounts receivable	150,000	(5)		
Inventory	120,000	(8)		
Prepaid expenses	5,000	(11)		
Total current assets			$ 375,000	(10)
Fixed Assets:				
Land, buildings and equipment	$292,500	(15)		
Less accumulated depreciation	97,500	(16)		
Total fixed assets			195,000	(14)
Intangible Assets			30,000	(13)
Total assets			$ 600,000	(12)
Current Liabilities:				
Accounts payable	$100,000	(17)		
Accrued expenses payable	25,000	(18)		
Total current liabilities			$ 125,000	(9)
Long-term Liabilities:				
5% Bonds payable—due 1970			75,000	(21)
Total liabilities			200,000	(20)
Stockholders' Equity:				
6% Preferred stock, $100 par value, 500 shares authorized, issued and outstanding (25)	$ 50,000	(24)		
Common stock, $10 par value, 22,500 shares authorized, issued and outstanding (22)	225,000	(23)		
Contributed capital in excess of par value	27,500	(26)		
Retained earnings	97,500	(27)		
Total stockholders' equity			400,000	(19)
Total liabilities and stockholders' equity			$ 600,000	(28)

2.

Argo Sales Corporation
INCOME STATEMENT
For the Year Ended December 31, 1968

Net sales			$1,200,000	(1)
Less cost of goods sold			720,000	(3)
Gross profit on sales			480,000	(2)
Selling expenses	$240,000	(4)		
Administrative expenses	116,250	(30)		
Interest expense	3,750	(29)	360,000	
Net income			$ 120,000	

Notes:

Supporting Computations for Amounts on Financial Statements

(1) *Sales*

$$\frac{\text{Net income}}{\text{Net profit rate}} = \frac{\$120{,}000}{.10} = \$1{,}200{,}000$$

(2) *Gross Profit*
Sales $\times$ gross profit rate = \$1,200,000 $\times$ .40 = \$480,000

(3) *Cost of Goods Sold*
Sales — gross profit = \$1,200,000 – \$480,000 = \$720,000

(4) *Selling Expenses*
Sales $\times$ selling expenses rate = \$1,200,000 $\times$ .20 = \$240,000

(5) *Accounts Receivable*

$$\frac{\text{Sales}}{\text{Accounts receivable turnover}} = \frac{\$1{,}200{,}000}{8} = \$150{,}000$$

(6) *Cash*

$$\text{Quick assets} = \frac{\text{Accounts receivable}}{\text{\% of quick assets in accounts receivable}} = \frac{\$150{,}000}{.60} = \$250{,}000$$

Cash = quick assets $\times$ % of quick assets in cash = \$250,000 $\times$ .08 = \$20,000

(7) *Marketable Securities*
Quick assets $\times$ % of quick assets in securities = \$250,000 $\times$ .32 = \$80,000

(8) *Inventory*

$$\frac{\text{Cost of goods sold}}{\text{Inventory turnover}} = \frac{\$720{,}000}{6} = \$120{,}000$$

(9) *Current Liabilities*

$$\frac{\text{Quick Assets}}{2^*} = \frac{\$250{,}000}{2} = \$125{,}000$$

*From acid-test ratio

(10) *Current Assets*
Current liabilities $\times$ 3* = \$125,000 $\times$ 3 = \$375,000
*From current ratio

(11) *Prepaid Expenses*
Current assets—(cash + securities + receivables + inventory) = \$375,000—(\$20,000 + \$80,000 + \$150,000 + \$120,000) = \$5,000

(12) *Total Assets*

$$\frac{\text{Sales}}{\text{Asset turnover}} = \frac{\$1{,}200{,}000}{2} = \$600{,}000$$

(13) *Intangible Assets*

$$\frac{\text{Total assets}}{20^*} = \frac{\$600{,}000}{20} = \$30{,}000$$

*From ratio of total assets to intangibles

(14) *Fixed Assets* (Net)
Total assets—(current assets + intangibles) = \$600,000—(\$375,000 + \$30,000) = \$195,000

(15) *Land, Buildings and Equipment*

Let: A = land, buildings and equipment
D = accumulated depreciation
N = Net fixed assets

A — D = N
A — (A/3*) = $195,000
2/3A = $195,000
A = $292,500
*From ratio of depreciation to cost

(16) *Accumulated Depreciation*

$$\frac{\text{Land, buildings and equipment}}{3^*} = \frac{\$292{,}500}{3} = \$97{,}500$$

*From ratio of depreciation to cost

(17) *Accounts Payable*

$$\frac{\text{Accounts receivable}}{1.5^*} = \frac{\$150{,}000}{1.5} = \$100{,}000$$

*From ratio of accounts receivable to accounts payable

(18) *Accrued Expenses Payable*

Current liabilities — accounts payable = $125,000 — $100,000 = $25,000

(19) *Total Stockholders' Equity*

Working capital × 1.6* = 1.6 ($375,000 — $125,000) = $400,000
*From ratio of working capital to stockholders' equity

(20) *Total Liabilities*

Total assets — stockholders' equity = $600,000 — $400,000 = $200,000

(21) *5% Bonds Payable—Due 1970*

Total liabilities — current liabilities = $200,000 — $125,000 = $75,000

(22) *Common Stock Shares*

$$\frac{\text{Net income — preferred dividends}}{\text{Earnings per share}} = \frac{\$120{,}000 - \$3{,}000}{\$5.20} = 22{,}500$$

(23) *Common Stock*

Shares × par value = $22,500 × $10 = $225,000

(24) *Preferred Stock*

$$\frac{\text{Dividends paid}}{\text{Dividend rate}} = \frac{\$3{,}000}{.06} = \$50{,}000$$

(25) *Preferred Stock Shares*

$$\frac{\text{Preferred stock}}{\text{Par value}} = \frac{\$50{,}000}{\$100} = 500$$

(26) *Contributed Capital in Excess of Par Value*

Common × % premium = $225,000 × .10 =	$22,500
Preferred × % premium = $50,000 × .10 =	5,000
Total premium	$27,500

(27) *Retained Earnings*

Stockholders' equity — (common + preferred + premium) = $400,000 — ($225,000 + $50,000 + $27,500) = $97,500

(28) *Total Liabilities and Stockholders' Equity*
Total assets = total liabilities and stockholders' equity = $600,000

(29) *Interest Expense*
Bonds payable × interest rate = $75,000 × .05 = $3,750

(30) *Administrative Expenses*

Gross profit		$480,000
Less net income		120,000
Total expenses		360,000
Less: Selling expenses	$240,000	
Interest	3,750	243,750
Administrative expenses		$116,250

Proof statistics supplied:
1. Debt to equity ratio = $200,000 to $400,000 = 1 to 2
2. Times interest earned =

$$\frac{\text{Income before interest}}{\text{interest}} = \frac{\$120{,}000 + \$3{,}750}{\$3{,}750} = 33$$

b. 1.

RATE OF RETURN ON STOCKHOLDERS' EQUITY

$$\frac{\text{Net income}}{\text{Stockholders' equity}} = \frac{\$120{,}000}{\$400{,}000} = 30\%$$

2.

PRICE-EARNINGS RATIO FOR COMMON STOCK

Market value per share to earnings per share =
$78.00 to $5.20 = 15 to 1

3.

DIVIDENDS PAID PER SHARE OF COMMON STOCK

Net income	$120,000
Less dividends on preferred stock	3,000
*Dividends on common stock	$117,000

$$\frac{\text{Dividends on common}}{\text{Shares of common}} = \frac{\$117{,}000}{22{,}500} = \$5.20$$

*All earnings were paid out as dividends since there was no change in beginning and ending stockholders' equity

4.

DIVIDENDS PAID PER SHARE OF PREFERRED STOCK

$$\frac{\text{Dividends on preferred}}{\text{Shares of preferred}} = \frac{\$3{,}000}{500} = \$6$$

5.

YIELD ON COMMON STOCK

$$\frac{\text{Dividends per share}}{\text{Market value}} = \frac{\$\ 5.20}{\$78.00} = 6\text{-}2/3\%$$

Solution 3

a. 1.

Wells and Williams
SCHEDULE PRESENTING THE COMPUTATION OF THE OVER-OR-(UNDER)-STATEMENT OF GROSS PROFIT ON INSTALLMENT SALES CONTRACTS

	1966	*1967*	*1968*
Total cash collections	$51,000	$55,000	$60,000
Less collections of prior year's sales			
($18,000 — $10,000)		8,000	
[$10,000 + ($24,000 — $11,000)]			23,000
Collections for year's sales	51,000	47,000	37,000
Add year's sales outstanding	18,000	24,000	19,000
Total year's sales	69,000	71,000	56,000
Gross profit per cent	.30	.32	.33
Gross profit recognized per books	20,700	22,720	18,480
Less gross profit realized on sales made in:			
1966 ($51,000 × 30%)	15,300		
1966 ($8,000 × 30%)		2,400	
1966 ($10,000 × 30%)			3,000
1967 ($47,000 × 32%)		15,040	
1967 ($13,000 × 32%)			4,160
1968 ($37,000 × 33%)			12,210
Total realized gross profit	15,300	17,440	19,370
Over-or-(under)-statement of gross profit on installment sales	$ 5,400	$ 5,280	$ (890)

2.

SCHEDULE PRESENTING THE COMPUTATION OF UNDERSTATEMENT OF BAD DEBTS EXPENSE

	1966	*1967*	*1968*
Bad debts expense—allowance method:			
Bad debts realized to date	$ 1,700	$ 1,240	$ 825
Estimated future uncollectibles		250	950
Total bad debts expense—allowance method	1,700	1,490	1,775
Less bad debts per books	800	1,390	1,575
Understatement of bad debts expense	$ 900	$ 100	$ 200

3.

SCHEDULE PRESENTING THE COMPUTATION OF UNDERSTATEMENT OF SALARIES EXPENSE

	1966	*1967*	*1968*
Unrecorded accrued salaries expense	$ 600	$ 650	$ 820
Less accrued salaries of prior year charged to expense on books		600	650
Understatement of salaries expense	$ 600	$ 50	$ 170

4.

SCHEDULE PRESENTING THE COMPUTATION OF OVERSTATEMENT OF INSURANCE EXPENSE

	1966	*1967*	*1968*
Prepaid insurance charged to expense	$ 330	$ 420	$ 580
Less prepaid insurance of prior period charged as expense		330	420
Overstatement of insurance expense	$ 330	$ 90	$ 160

b.

SCHEDULE PRESENTING THE COMPUTATION OF THE ADJUSTMENTS NECESSARY TO PROPERLY REPORT CAPITAL BALANCES

		Adjustments to Capital Balances			
	(Over)-or-Under-Statement of	*Wells*		*Williams*	
Year	*Net Income*	*Ratio*	*Amount*	*Ratio*	*Amount*
1966	$ (7,000)	50%	$(3,500)	50%	$(3,500)
1967	(6,000)	50%	(3,000)	50%	(3,000)
1968	1,000	40%	400	60%	600
Totals	$(12,000)		$(6,100)		$(5,900)

( ) denotes reduction

c.

SCHEDULE PRESENTING THE COMPUTATION OF MEYER'S CAPITAL AND GOODWILL UPON ADMISSION OF MEYER

Capital balances:	
Wells	$ 60,000
Williams	76,000
Total Capital of Wells and Williams	$136,000
Capital after admission of Meyer ($136,000 ÷ 4/5)	$170,000
Less capital of Wells and Williams	136,000
(1) Capital of Meyer	34,000
Less cash contribution of Meyer	25,000
(2) Goodwill to be recognized	$ 9,000

Solution 4

a. 1.

COMPUTATION OF PAYMENT TO PROVIDER FOR INPATIENT SERVICES UNDER THE DEPARTMENTAL RCC METHOD

Departments	*Charges for HI Program Beneficiaries*	*Total Charges*	*Percentage of HI Program Charges to Total Charges*	*Total Allowable Costs*	*Portion of Allowable Costs Allocable to Beneficiary Service*
Inpatient routine services (room, board, nursing)	$425,000	$1,275,000	33-1/3%	$1,350,000	$450,000
Inpatient ancillary service departments:					
X ray	56,000	200,000	28%	150,000	42,000
Operating room	57,000	190,000	30%	220,000	66,000
Laboratory	59,000	236,000	25%	96,000	24,000
Pharmacy	98,000	294,000	33-1/3%	207,000	69,000
Other	10,000	80,000	12-1/2%	88,000	11,000
Totals	280,000	1,000,000		761,000	212,000
Combined Totals	$705,000	$2,275,000		$2,111,000	662,000
Less interim payments received during year (12,000 days at $45)					540,000
Remaining balance to be reimbursed					$122,000

2.

COMPUTATION OF PAYMENT TO PROVIDER FOR INPATIENT SERVICES UNDER THE COMBINATION METHOD (WITH COST FINDING)

Routine services:		
Total inpatient days applicable to beneficiaries	15,000	
Average cost per diem (Note 1)	$ 33.75	
Total reimbursable cost of routine services		$506,250
Ancillary services:		
Total allowable costs	$761,000	
Ratio of beneficiary charges to total charges (Note 2)	28%	
Total reimbursable cost of ancillary services		213,080
Reimbursable cost of all inpatient services		719,330
Less interim payments received (12,000 days at $45)		540,000
Remaining balance to be reimbursed		$179,330

Notes: 1. $\dfrac{\text{Total allowable costs}}{\text{Total inpatient days for all patients}} = \dfrac{\$1,350,000}{40,000} = \$33.75$ Average cost per diem

2. $\dfrac{\text{Charges for HI program beneficiaries}}{\text{Total charges}} = \dfrac{\$\ 280,000}{\$1,000,000} = 28\%$ Ratio of beneficiary charges to total charges

b. Good Hope Hospital should elect to be reimbursed under the combination method because its reimbursement will be more under this method.

c. 1.

COMPUTATION OF THE AVERAGE TOTAL HOSPITAL CHARGE FOR A MEDICARE INPATIENT

$$\frac{\text{Total charges for HI inpatients}}{\text{Number of inpatients}} = \frac{\$705{,}000}{1{,}200} = \$587.50$$

2.

COMPUTATION OF THE AVERAGE CHARGE PER INPATIENT DAY FOR HI PATIENTS

$$\frac{\text{Total charges for HI inpatient}}{\text{Total inpatient days for HI inpatients}} = \frac{\$705{,}000}{15{,}000} = \$47.00$$

Solution 5

a. 1.

Commercial Products Corporation
SCHEDULE COMPUTING THE PROBABILITY OF UNIT SALES PER MONTH

Unit Sales per Month	*Number of Months*	*Probability*
4,000	6	6/30 = .2
5,000	15	15/30 = .5
6,000	9	9/30 = .3
Totals	30	1.0

2.

SCHEDULE OF MARGINAL INCOME FOR VARIOUS COMBINATIONS OF UNIT SALES AND UNITS MANUFACTURED

Unit	*Units Manufactured (and Purchased)*		
Sales	4,000	5,000	6,000
4,000	$60,000 (1)	$35,000 (2)	$10,000 (2)
5,000	55,000 (3)	75,000 (1)	50,000 (2)
6,000	50,000 (3)	70,000 (3)	90,000 (1)

Notes: **Computation of Marginal Income**

(1) When all units manufactured are sold:
4,000 × ($40 — $25) = $60,000
5,000 × ($40 — $25) = 75,000
6,000 × ($40 — $25) = 90,000

(2) Reduction per 1,000 units when more units are manufactured than are sold:
1,000 × $25 = $25,000

(3) Reduction per 1,000 units when units must be purchased to fill sales orders:
1,000 × [$40 — ($40 + $5)] = $5,000

3. **SCHEDULE COMPUTING EXPECTED MARGINAL INCOME IF 5,000 UNITS ARE MANUFACTURED AND ALL SALES ORDERS ARE FILLED**

Unit Sales	*Probability*	*Marginal Income*	*Expected Value*
4,000	.2	$35,000	$ 7,000
5,000	.5	75,000	37,500
6,000	.3	70,000	21,000
	Expected average monthly marginal income		$65,500

b. 1. **COMPUTATION OF MARGINAL INCOME IF 5,000 UNITS ARE MANUFACTURED WITH SUBSTITUTE INGREDIENT AND ALL SALES ORDERS ARE FILLED**

Unit Sales	*Marginal Income*
4,000 × [$40 — ($25 — $12 + $18)] — 1,000 × ($25 — $12 + $18) =	$ 5,000
5,000 × [$40 — ($25 — $12 + $18)] =	45,000
(6,000 × $40) — [5,000 ($25 — $12 + $18) + (1,000 × $45)] =	40,000

2. **SCHEDULE COMPUTING EXPECTED MARGINAL INCOME WITH PROBABILITY OF STRIKE AT SUPPLIER'S PLANT AND ALL SALES ORDERS FILLED**

Expected marginal income from manufacturing		$65,000
Probability of no strike (1 — .6)		.4
Expected value from manufacturing		26,000
Expected marginal loss from purchasing if strike occurs	$25,000	
Probability of strike	.6	
Expected loss		(15,000)
Expected marginal income		$11,000

3. For the safest alternative the Corporation should order the substitute ingredient during the anticipated strike period because the expected value in marginal income is greater. (There is a 40 per cent chance that ordering the primary ingredient would produce the expected $65,000 marginal income but a 60 per cent chance that it would produce a $25,000 marginal loss. Thus the net expectation is $11,000 marginal income compared to $35,000 from manufacturing using the substitute ingredient.)

4. Yes, purchase the compound from the competitor. The total future income which might be lost from losing a customer cannot be estimated, but it is estimated that 80 per cent of the customers would not again buy from the Corporation if orders were refused. Thus the Corporation must weigh losing $5 per unit currently against losing $25 variable production cost on unsold future units plus the loss of the marginal income on those sales and on any other products which those customers might order.

Solution 6

Jacob Vocational School
WORKSHEET TO ESTABLISH ACCOUNT BALANCES
For the Year Ended August 31, 1968

Debits	*Trial Balance February 29, 1968*	*Adjustments and Transactions*		*General Current Fund*	*Restricted Current Fund*	*Plant Funds—Invested In Plant*	*E. T. Pearce Annuity Fund*
		Debit	*Credit*				
Cash for general current operations	$258,000		(3)$ 53,600	$204,400			
Cash for restricted current uses	30,900				$30,900		
Stock donated by D. E. Marcy	11,000		(5) 11,000				
Bonds donated by E. T. Pearce	150,000						$150,000
Building	33,000					$ 33,000	
Land	22,000					22,000	
General current operating expenses	38,000	(3)$ 14,000		52,000			
Faculty recruitment expenses	4,100				4,100		
Payment for director's residence from general funds		(3) 600		600			
Equipment		(4) 47,000				47,000	
Payment for director's residence from restricted funds		(5) 10,600			10,600		
Loss on sale of investments—restricted funds		(5) 400			400		
Cash for annuity fund		(6) 5,500					5,500
Due from annuity fund		(7) 5,500		5,500			
Total debits	$547,000			$262,500	$46,000	$102,000	$155,500
Credits							
Mortgage payable on fixed assets	$ 30,000					$ 30,000	
Income from gifts for general operations	210,000			$210,000			
Income from gifts for restricted uses	196,000	(1) 150,000			$46,000		
Student fees	31,000		(3) 8,000	39,000			
Unappropriated surplus	80,000	(2) 25,000		8,000			
		(3) 47,000					
Annuity fund balance			(1) 150,000				$150,000
Investment in plant—current funds			(2) 25,000			72,000	
			(4) 47,000				
Due to general current fund			(6) 5,500				5,500
Deferred income from annuity fund			(7) 5,500	5,500			
Total credits	$547,000	$305,600	$305,600	$262,500	$46,000	$102,000	$155,500

Jacob Vocational School
ADJUSTING AND TRANSACTIONS ENTRIES
For Year Ended August 31, 1968
(Not Required)

(1)		
Income from gifts for restricted uses	$150,000	
Annuity fund balance		$150,000
To transfer gift of bonds to annuity fund.		
(2)		
Unappropriated surplus	25,000	
Investment in plant—current funds		25,000
To apportion fixed assets to Plant Funds—Invested in Plant group of accounts.		
(3)		
General current operating expenses	14,000	
Unappropriated surplus	47,000	
Payment for director's residence from general current fund	600	
Student fees		8,000
Cash for general current operations		53,600
To record cash transactions of the General Current Fund March 1 to August 31, 1968.		
(4)		
Equipment	47,000	
Investment in plant—current funds		47,000
To record purchase of equipment in Plant Funds—Invested in Plant group of accounts.		
(5)		
Payment for director's residence from restricted funds	10,600	
Loss on sale of investments—restricted funds	400	
Stock donated by D. E. Marcy		11,000
To record sale of Trans, Inc. stock and payment of expenses for director's residence.		
(6)		
Cash for annuity fund	5,500	
Due to general current fund		5,500
To record earnings of annuity fund which are to be made available to the general current fund next period.		
(7)		
Due from annuity fund	5,500	
Deferred income from annuity fund		5,500
To record in general current fund earnings of annuity fund which are to become available next period.		

ACCOUNTING PRACTICE—PART II

May 8, 1969; 1:30 to 6:00 p.m.

Solution 1

Tyme Motor Freight, Inc.

SCHEDULE OF INCOME TAXABLE AS ORDINARY INCOME

For Year Ended December 31, 1968

Net income per books before taxes			$70,100
Add:			
Partial write-off of Vans, Inc. stock		$ 4,200	
Loss on wash sale of Imke, Inc. stock		700	
Excess of freight claim losses recorded on books ($12,000 — $2,200)		9,800	
Accrued interest expense		360	
Overloading fines		2,500	
Advertisment in the program for a political convention		1,200	18,760
Total			$88,860
Less:			
T.V. Advertising cost not deducted on books (5 × $900)		4,500	
Additional depreciation		3,000	
Sec. 1231 gains on sale of fixed assets:			
Warehouse No. 15	$7,000		
Land	5,500		
Warehouse No. 19	5,380	17,880	25,380
Income taxable as ordinary income			$63,480

Computation of Gain on Sale of Certain Fixed Assets

	Warehouse No. 15	2 Transport Trucks	Land
Selling price	$ 58,000	$ 7,500	$31,000
Cost	100,000	20,000	25,500
Less accumulated depreciation	49,000	14,000	—
Book value	51,000	6,000	25,500
Sec. 1231 gain	$ 7,000		$ 5,500
Sec. 1245 gain		$ 1,500	

Computation of Gain on Sale of Warehouse No. 19

Selling Price				$65,000
Cost			$110,000	
Less accumulated depreciation			59,500	
Book value				50,500
Gain per books				14,500
Depreciation recorded 1962-67			59,500	
Less depreciation recorded prior to 1964			19,500	
Sum-of-years' digits depreciation after 1963			40,000	
Less straight-line depreciation after 1963 [4/20 × ($110,000 — $5,000)]			21,000	
Additional depreciation			19,000	
Maximum per cent		100%		
Months held	72			
Less first 20 months	20			
Applicable months × 1%		52%		
Applicable percentage			48%	
Sec. 1250 gain				9,120
Sec. 1231 gain				$ 5,380

Computation of Additional Depreciation on Assets Acquired in 1968

Cost of assets acquired	$121,000
Additional first-year 20% depreciation (20% × $121,000)	$ 24,200
Maximum allowable additional first-year 20% depreciation (20% × $10,000)	$ 2,000
Add straight-line depreciation allowable per tax return ($121,000 — $2,000) ÷ 7	17,000
Total depreciation allowable per tax return	$ 19,000
Less straight-line depreciation per books ($121,000—$9,000) ÷ 7	16,000
Additional depreciation deductible in tax return	$ 3,000

Solution 2

a.

Derr Sales Corporation

FINANCIAL STATEMENT ANALYSES

1. Number of days' sales uncollected $= \dfrac{\text{Accounts receivable} \times 300}{\text{Sales}}$

$$= \frac{70{,}952 \times 300}{760{,}200} = 28 \text{ days}$$

2. Inventory turnover $= \dfrac{\text{Cost of goods sold}}{\text{Inventory}}$

$$= \frac{452{,}500}{113{,}125} = 4 \text{ times}$$

3. Number of days' operations to cover the working capital deficit $= \dfrac{\text{Working capital deficit}}{\text{Funds generated from operations}} \times 300$

$$= \frac{33{,}000}{99{,}000} \times 300 = 100 \text{ days}$$

Computation of Funds Generated by Operations

Net Income	$76,020
Add: Depreciation not requiring funds	22,980
Funds generated by operations	$99,000

4. Return on total assets $= \dfrac{\text{Sales}}{\text{Total assets}} \times \dfrac{\text{Net income}}{\text{Sales}}$

$$= \frac{\$760{,}200}{\$190{,}050 + \$352{,}950} \times \frac{\$\ 76{,}020}{\$760{,}200}$$

$$= 1.4 \times 10\% = 14\%$$

b. 1. Return on total assets $= \dfrac{\text{Net income}}{\text{Book value of total assets}} = \dfrac{\$\ 50{,}140}{\$545{,}000} = 9.2\%$

Computation of net income:			
Sales (100,000 × $8.30)			$830,000
Less: Variable costs (100,000 × $6.00)		$600,000	
Fixed costs		129,720	729,720
Net income before income taxes			100,280
Less income taxes — 50%			50,140
Net income after income taxes			$ 50,140
Computation of book value of assets:			
1968 ratio of current assets to sales:			
$190,050 ÷ $760,200 = 25%			
1969 current assets:			
($830,000 × 25%)		$207,500	
1969 land, building and equipment:			
1968 book value	$352,950		
Less 1969 depreciation	15,450	337,500	
Total book value of assets		$545,000	

2. **ANALYSIS OF THE VARIATION IN GROSS MARGIN**
For the Period 1968 to 1969

Causes of the $69,800 increase in sales:		
Sales price variation, 100,000 × ($8.40 — $8.30)	$(10,000)	
Sales volume variation, $8.40 × (100,000 — 90,500)	79,800	
Increase in sales		$ 69,800
Causes of the $37,500 increase in cost of sales:		
Cost variation, 100,000 × ($5.00 — $4.90)	$(10,000)	
Volume variation, $5.00 × (100,000 — 90,500)	47,500	
Increase in cost of sales		37,500
Increase in gross margin		$ 32,300

Computation of Variation in Gross Margin
(Not required)

	1968	*1969*	*Increase*
Sales:			
Units	90,500	100,000	
Unit sales price	$ 8.40	$ 8.30	
Amount	$760,200	$830,000	$69,800
Cost of goods sold:			
Units	90,500	100,000	
Unit cost	$ 5.00	$ 4.90	
Amount	$452,500	$490,000	37,500
Gross margin	$307,700	$340,000	$32,300

Solution 3

a.

Ruidoso Ski Lodge
PROJECTED INCOME STATEMENT
For the Year Ended March 15, 1970

	Ski Shop	*Lodge*	*Total*
Revenue:			
$27,000 × 80/90	$24,000		$ 24,000
$108,000 × 80/90		$96,000	96,000
Total	$24,000	$96,000	$120,000
Costs:			
Cost of goods sold ($24,000 × 55%)	$13,200		$ 13,200
Supplies:			
$24,000 × 5%	1,200		1,200
$96,000 × 7%		6,720	6,720
Utilities:			
$24,000 × 1%	240		240
$96,000 × 2%		1,920	1,920
Salaries	1,620	32,400	34,020
Insurance	810	9,720	10,530
Property taxes	540	8,080	8,620
Depreciation	1,080	28,080	29,160
Total costs	18,690	86,920	105,610
Income before extraordinary items	$ 5,310	$ 9,080	14,390
Add gain on sale of restaurant equipment			1,200
Net income			$ 15,590

b. 1.

PROJECTED MARGINAL INCOME OF OPERATING GIFT SHOP AND LODGE FROM MARCH 15 TO NOVEMBER 15

	Gift Shop	*Lodge*	*Total*
Marginal revenue:			
($27,000 × 2) × 50/90	$30,000		
(100 × 50%) × (30 × 8) × $7		$84,000	
Total marginal revenue			$114,000
Marginal costs:			
Cost of goods sold:			
($30,000 × 55%)	16,500		
Supplies:			
($30,000 × 5%)	1,500		
($7,560 × 2) × 50/90		8,400	
Utilities:			
($30,000 × 1%)	300		
($2,160 × 2) × 50/90		2,400	
Salaries:			
($1,620 × 2)	3,240		
($32,400 — $5,400) × 2		54,000	
Conversion costs	2,000		
Total marginal costs	23,540	64,800	88,340
Marginal income (loss)	$ 6,460	$19,200	$ 25,660

b. 2.

COMPUTATION OF MINIMUM ROOM RATE FROM MARCH 15 TO NOVEMBER 15 TO ALLOW LODGE TO BREAK EVEN

$$\text{Room rate} = \frac{\text{total added costs for 8 months}}{\text{rooms to be rented for 8 months}}$$

$$= \frac{\$8{,}400 + \$2{,}400 + \$54{,}000}{(100 \times 50\%) \times (30 \times 8)}$$

$= \$5.40$ per room per day to break even.

Solution 4

a. 1.

Norwood Corporation
EQUIVALENT UNITS OF PRODUCTION FOR MATERIAL, LABOR AND OVERHEAD
For the Year Ended December 31, 1968

	Equivalent Units		
	Material	*Labor and Overhead*	
Beginning inventory—work in process	0	(60%)	6,000
Units started and finished [(230,000 ÷ 2) — 15,000]	100,000		100,000
Ending inventory—work in process	15,000	(33-1/3%)	5,000
Total	115,000		111,000

2. COMPUTATION OF NUMBER OF UNITS SOLD
For the Year Ended December 31, 1968

Units transferred to finish goods during year	110,000
Add beginning finished goods inventory	20,000
Units available for sale	130,000
Less units in ending finished goods inventory	12,000
Units sold during year	118,000

3. COMPUTATION OF STANDARD UNIT COSTS UNDER DIRECT AND ABSORPTION COSTING
For the Year Ended December 31, 1968

	Direct Costing	*Absorption Costing*
Marsh, 2 pounds	$ 3.00	$ 3.00
Labor	6.00	6.00
Variable manufacturing overhead	1.00	1.00
Fixed manufacturing overhead		1.10
Total standard unit costs	$10.00	$11.10

4. COMPUTATION OF OVER- OR UNDER-APPLIED FIXED MANUFACTURING OVERHEAD
For the Year Ended December 31, 1968

Equivalent units of production for overhead	111,000
Standard fixed manufacturing overhead per unit	$ 1.10
Total fixed manufacturing overhead applied	$122,100
Less actual fixed manufacturing overhead	121,000
Over-applied fixed manufacturing overhead	$ 1,100

b.

Norwood Corporation
COMPARATIVE STATEMENT OF COST OF GOODS SOLD
For the Year Ended December 31, 1968

	Direct Costing	*Absorption Costing*
Beginning finished goods inventory:		
(20,000 @ $10)	$ 200,000	
(20,000 @ $11.10)		$ 222,000
Add cost of good manufactured:		
(110,000 @ $10)	1,100,000	
(110,000 @ $11.10)		1,221,000
Total cost of goods available for sale	1,300,000	1,443,000
Less ending finished goods inventory:		
(12,000 @ $10)	120,000	
(12,000 @ $11.10)		133,200
Total	1,180,000	1,309,800
Less over-applied fixed manufacturing overhead		1,100
Cost of goods sold	$1,180,000	$1,308,700

Solution 5

Major Corporation and Subsidiaries
WORKING PAPERS TO PREPARE A CONSOLIDATED BALANCE SHEET
December 31, 1968

	Major Corporation	Minor Corporation	Mode Corporation	Adjustments and Eliminations Debit	Adjustments and Eliminations Credit	Consolidated Balance Sheet
Assets						
Cash	$ 100,000	$ 75,000	$ 95,000			$ 270,000
Accounts receivable	158,200	210,000	105,000		(3)$ 22,400	450,800
Inventories	290,000	90,000	115,000		(3) 6,400	488,600
Advance to Minor Corporation	17,000				(5) 17,000	
Dividends receivable	24,000				(6) 24,000	
Property, plant and equipment	777,600	325,000	470,000			1,572,600
Allowance for depreciation	(180,000)	(55,000)	(160,000)			(395,000)
Investment in Minor Corporation:						
6% bonds	23,800				(4) 23,800	
Common stock	308,600				(1) 308,600	
Investment in Mode Corporation:						
Preferred stock	7,000				(2) 7,000	
Common stock	196,000				(2) 196,000	
Totals	$1,722,200	$645,000	$625,000			$2,387,000
Liabilities and Capital						
Accounts payable	$ 170,000	$ 96,000	$ 86,000	(3)$ 22,400		$ 312,600
				(5) 17,000		
Notes payable	45,000	14,000	44,000			103,000
Bonds payable	285,000	150,000	125,000	(4) 25,000		535,000
Discount on bonds payable	(8,000)	(12,000)			(4) 2,000	(18,000)
Dividends payable	22,000	30,000		(6) 24,000		28,000
Preferred stock, $20 par	400,000					400,000
Mode Corporation			50,000	(2) 5,000		45,000M
Common stock, $10 par	600,000					600,000
Minor Corporation		250,000		(1) 200,000		50,000M
Mode Corporation			200,000	(2) 140,000		60,000M
Retained earnings	208,200			(1) 15,000	(7) 11,600	199,040
				(3) 5,120		
				(4) 640		
Minor Corporation		117,000		(1) 93,600		21,960M
				(3) 1,280		
				(4) 160		
Mode Corporation			120,000	(2) 58,000		50,400M
				(7) 11,600		
Totals	$1,722,200	$645,000	$625,000	$618,800	$618,800	$2,387,000

M = Minority's interest

Major Corporation and Subsidiaries
Adjusting and Elimination Entries
December 31, 1968

(Not Required)

(1)

Retained earnings—Major Corporation				$ 15,000	
Common stock—Minor Corporation (80% × $250,000)				200,000	
Retained earnings—Minor Corporation (80% × $117,000)				93,600	
Investment in Minor Corporation stock					$308,600
To eliminate reciprocal elements in investment and equity accounts and to correct retained earnings of Major Corporation.					
Net income of Minor Corporation 1/1/67-4/1/67 recorded in error (¼ × $12,000)			$ 3,000		
Net income of Minor Corporation for 1968 ($32,000 ÷ 80%)		$40,000			
Net income recorded by Major Corporation in 1968		$32,000			
Less Major Corporation's share in 1968:					
1/1/68-6/30/68					
20% × ½ ($40,000)	$ 4,000				
7/1/68-12/31/68					
80% × ½ ($40,000)	16,000	20,000	$ 12,000		
Total excess net income of Minor Corporation recorded in error			$ 15,000		

(2)

Preferred stock—Mode Corporation (10% × $50,000)			5,000	
Common stock—Mode Corporation (70% × $200,000)			140,000	
Retained earnings—Mode Corporation			58,000	
Investment in Mode Corporation—Preferred stock				7,000
Investment in Mode Corporation—Common stock				196,000
To eliminate reciprocal elements in investment and equity accounts.				
Mode Corporation retained earnings 12/31/68			$120,000	
Less earnings for 1968			20,000	
Mode Corporation retained earnings at beginning of year			$100,000	
Mode Corporation retained earnings identified with:				
Preferred stock				
($50,000 ÷ $250,000) × $100,000 =	$20,000			
Major Corporation interest (10% × $20,000)		$ 2,000		
Common stock				
($200,000 ÷ $250,000) × $100,000 =	$80,000			
Major Corporation interest (70% × $80,000)		56,000		
Major Corporation interest in retained earnings of Mode Corporation, 1/2/68		$ 58,000		

(3)

Accounts payable—Mode Corporation			22,400	
Retained earnings—Major Corporation (80% × $6,400)			5,120	
Retained earnings—Minor Corporation (reducing minority interest 20% × $6,400)			1,280	
Inventories				6,400
Accounts receivable—Minor Corporation				22,400
To eliminate the intercompany profit from inventory and the reciprocal receivable and payable accounts.				
Sales price of merchandise	$22,400			
Cost of merchandise ($22,400 ÷ 1.4) =	16,000			
Profit on merchandise	$ 6,400			

(4)

Retained earnings—Major Corporation (80% × $800)			640	
Retained earnings—Minor Corporation (20% × $800)			160	
Bonds Payable—Minor Corporation			25,000	
Investment in Minor Corporation bonds				23,800
Discount on bonds payable—Minor Corporation				2,000
To eliminate reciprocal elements in bond and bond discount accounts.				
Discount on bonds payable to be eliminated ($25,000 ÷ $150,000) × $12,000 =		$ 2,000		
Face value of intercompany bonds	$25,000			
Less carrying value by Major Corporation	23,800			
Discount on bonds held		1,200		
Difference in carrying value of the bonds		$ 800		

(5)

Accounts payable	17,000	
Advance to Minor Corporation		17,000
To eliminate intercompany receivable and payable.		

(6)

Dividends payable (80% × $30,000)	24,000	
Dividends receivable		24,000
To eliminate intercompany dividends receivable and payable.		

(7)

Retained earnings—Mode Corporation			11,600	
Retained earnings—Major Corporation				11,600
To transfer to Major Corporation its share of the earnings of Mode Corporation for 1968				
Portion of earnings allocable to:				
Preferred stock				
($50,000 ÷ $250,000) × $20,000 =	$ 4,000			
Major Corporation's interest	.10	$ 400		
Common stock				
($200,000 ÷ $250,000) × $20,000 =	$16,000			
Major Corporation's interest	.70	11,200		
Major Corporation's interest in Mode Corporation's earnings in 1968		$ 11,600		

AUDITING

May 8, 1969; 8:30 a.m. to 12:00 m.

Answer 1

1. d	9. b
2. c	10. a
3. a	11. d
4. b	12. c
5. b	13. c
6. c	14. d
7. d	15. a
8. a	16. b

Answer 2

a. Generally accepted auditing standards require that a CPA render an opinion on the fairness of the financial statements which he has examined in an auditing engagement. A CPA prefers to undertake each examination with the objective of rendering an unqualified opinion. If the scope of the examination were limited, however, it is very likely that his auditor's opinion would be qualified. It is also possible that the CPA would have to disclaim an opinion on the overall fairness of the financial statements; if warranted the CPA could render a piecemeal opinion on the fairness of the accounts examined with his disclaimer. It would be unusual for a scope limitation to be imposed for items so immaterial that an unqualified opinion could be rendered.

The greatest handicap to the CPA from a scope limitation is that he cannot determine whether the excluded accounts contain transactions which should have been recorded in the accounts being examined. The possibility that an excluded account contains an improperly recorded transaction of material amount may cause the CPA to be unable to express an opinion even though otherwise warranted. The CPA's inability to form an opinion on the overall fairness of the statements would require that a disclaimer of opinion be rendered rather than a qualified opinion. (Because the CPA must disclaim any opinion on the fairness of the excluded accounts, the fact that a transaction which should have been recorded in an excluded account was not recorded does not handicap the rest of the CPA's examination.)

b. A CPA who issues a piecemeal opinion with a disclaimer of opinion on the overall fairness of the financial statements should state that an opinion is not intended and indicate clearly the limitation of the piecemeal opinion to individual accounts. It does not matter whether the accounts are named on which an opinion is expressed or the accounts on which he does not express an opinion are specifically excluded. The clearer method should be used. When a CPA renders a piecemeal opinion on certain accounts, a more extensive examination of these accounts may be required than would be required if he were expressing an opinion on the financial statements as a whole. The significant point about a piecemeal opinion with a disclaimer is that the CPA does not express an opinion on the overall fairness of the financial statements as a whole and he should use great care in wording his opinion so that others may not draw a misleading inference from it. Specifically, the piecemeal opinion should not overshadow or contradict the basic position that the CPA has no opinion on the overall fairness of financial statements.

c. Neither the scope of a CPA's examination nor the kind of auditor's opinion he renders will be affected directly by a client's assurance that his auditor's report will be distributed only internally. The scope of work done by the CPA to support a given type of opinion or the type of opinion the CPA renders based on a given scope of work will not change regardless of who plans to use the report or the use planned for it. The CPA's opinion is based on his evaluation of the evidence he obtains during his examination and the scope of his examination must be broad enough that competent evidence can be obtained in sufficient quantity. Only after the evidence is obtained and evaluated can the CPA form his opinion and the opinion will not be affected by the fact that the auditor's report will be used only internally by the client.

After the CPA issues his auditor's report it belongs to the client. The client may forget his promise to the CPA and distribute the report externally. A client will probably consider the use planned for the report when discussing the engagement with the CPA prior to the examination and audit scope restrictions which may affect the CPA's opinion may be imposed by the client at that time. But in such a case the scope is reduced because the client refuses to authorize the work which the CPA must do to express an unqualified opinion on the financial statements and not because of the use planned for the auditor's report.

Answer 3

a. No. In a first examination the CPA's attention cannot be confined to activity in the year under examination because (1) some balance sheet accounts include material amounts which originated in prior years, (2) some income and expense accounts include entries which are based on decisions or transactions of prior years, and (3) consistency over the years in the application of generally accepted accounting principles is necessary for fairly presented financial statements. Also, some audit testing of a nonrecurring nature will be necessary in an initial engagement because the CPA does not have the benefits of (1) familiarity with the company's history, personnel, system and operations, (2) information regarding the composition and reliability of beginning of the year balances, and (3) preceding year's audit working papers. Consequently, in the first examination the CPA will require such basic corporation documents as by-laws, articles of incorporation, minutes since incorporation, organization charts and work-flow charts and must comprehensively evaluate internal control to determine the scope of his audit testing.

b. The audit program procedures which the CPA should use to satisfy himself as to the January 1, 1968 balances in the Land, Building and Equipment and Accumulated Depreciation accounts of Hardware Manufacturing Company should include the following:

1. Read the minutes since incorporation in 1959 to ascertain that for major property transactions approved actions were recorded in the accounts and recorded transactions were properly approved.
2. Scan activity in the general ledger accounts since incorporation in 1959 for both fixed assets and accumulated depreciation to identify items of large amount and unusual nature which will warrant further investigation.
3. Examine support for principal property additions to ascertain that the capitalization includes costs of freight-in, installation, and major improvements and labor and overhead on self-constructed assets.
4. Ascertain that fixed assets donated by stockholders were recorded at fair market value on the date of donation and that contributed capital was properly credited.
5. If the fixed assets are to be reported at appreciated value rather than cost examine appraisal reports or other valid evidence supporting appreciation recorded on property and determine that the offsetting credit for the revaluation was made to a properly descriptive contributed capital account. Determine that the basis and treatment of the revaluation are stated in financial statements.
6. Compare the yearly totals of repairs and maintenance account balances and test abnormally high amounts to see that they do not include assets charged to expense.
7. Examine recorded deeds supporting ownership of buildings and determine that any encumbrance was properly reported in the financial statements.
8. Examine support (asset and accumulated depreciation) for recorded disposals or abandonments of major amount.
9. Tour the plants and account for major property items on hand to substantiate the reasonableness of subsidiary property records and to ascertain that idle, obsolete or worthless assets are not being reported at more than their fair value in the financial statements.

10. Test the assigned lives of depreciable assets and the bases, methods and computations of accumulated depreciation for propriety and consistency.
11. Review charges to the accumulated depreciation accounts to determine that they properly represent disposals, abandonments or extraordinary repairs.
12. Review the gains and losses on property disposals as an additional means of assurance that the depreciation lives and methods used are reasonable.
13. Scan federal income tax returns of prior years and revenue agents' reports pertaining to them to determine whether adjustments made for tax purposes should also be made on the books.
14. Determine that transactions involving the investment credit were properly recorded and that generally accepted principles of income tax allocation are being used for differences between tax depreciation and financial statement depreciation.
15. Examine insurance policies as to adequacy of insurance coverage for buildings and equipment.
16. Inspect real estate and property tax bills to further substantiate ownership and valuation of fixed assets.

Answer 4

a. Mr. Jordan should be told that accounting systems and internal controls vary widely depending on their individual applications. A system of accounting and internal control effectively used in an organization with 500 loan offices might be inappropriate or too costly for an organization with 4 loan offices. Some of the features of the larger company's system might be beneficially adapted, however, because both companies are in the loan business where great emphasis must be given to proper accountability for and control over the two major assets, cash and notes (loans) receivable. The CPA should listen to the description of the large company's system to determine its applicability and also suggest that he examine the existing system of accounting and internal control to learn its deficiencies and perhaps recommend changes to improve it. The CPA might find that he would spend less time in improving the existing system or in designing an appropriate system than in attempting to adapt the system employed by a large company in the same business.

If the accounting system employed by the large loan company is too elaborate to be installed without modification and the internal controls could not be established to achieve adequate separation of duties with existing employees, the CPA should explain that the system is inappropriate. By then explaining the usefulness of an accounting system which would provide specifically the information needed at the least cost and the efficiency of internal controls designed around present personnel the CPA could best serve this client.

b. Mr. Jordan should be cautioned against overconfidence as to what a better system could accomplish. An effective accounting system and good related internal controls may act as strong deterrents to fraud, but they will not make fraud impossible. In a large company internal controls and employee fidelity bonds are protection against fraud. In a small company with a limited number of personnel the segregation of duties to provide good internal control is less practicable unless additional employees are hired; often the best protection against fraud is close supervision by the owner. Mr. Jordan should be advised to invest a reasonable amount of money and effort to help prevent fraud, but he should also carry fidelity bonds on his employees to insure against loss if it should occur.

c. 1. The CPA should determine the scope of his audit work by developing a program which considers the internal controls in effect. The CPA must extend the scope of his examination if effective internal controls are missing. Review of internal controls will include consideration of the operations at the loan offices as well as controls exercised by Mr. Jordan and the frequency and effectiveness of supervisory and internal audit visits to the loan offices. The CPA's audit program should concentrate on weak spots which are evident from the evaluation of internal control and should recognize any specific suspicions of irregularity expressed by the client. If the CPA suspects fraud has been committed, the scope of his examination should be to the extent to satisfy him that the amount of the fraud would not be large enough to affect his opinion. If fraud exists and is material in amount, the CPA must extend the scope of his examination to determine the adjustment required for fair presentation of the financial statements. The CPA could then render an unqualified opinion on the adjusted financial statements reporting the loss from fraud.

2. The CPA is responsible for his opinion on the fairness of the financial statements. The usual examination is not primarily designed and cannot be relied upon to disclose defalcations and other similar irregularities. The CPA is not responsible for a failure to discover fraud unless he fails to use due professional care or does not perform his examination in accordance with generally accepted auditing standards. He must recognize that if fraud has occurred it could affect the fairness of the financial statements. After the CPA is satisfied that any fraud which exists is not material in amount, his responsibility would be to refer the matter to the client for follow up. If the client specifically requests an extension of the CPA's work because of suspicions of fraud the CPA may perform the requested work but he usually would not guarantee that he will discover all of the fraudulent acts.

The purpose of a CPA's examination is to furnish an opinion on the fairness of the client's financial statements. Although the ordinary examination should not be relied upon to discover embezzlement or prove its absence, if fraud exists it may be discovered during an examination. Also, a CPA's examination provides a psychological deterrent to those who consider committing fraud.

If a CPA's audit program were designed to discover all fraud the cost of the examination to the client would probably be prohibitive because a detailed audit would be required and even with a comprehensive audit program certain types of fraudulent activities (such as unrecorded transactions, forgeries or collusion) would still be difficult to detect.

Answer 5

a. 1. In tax practice a CPA must observe standards of professional accounting practice. The CPA may prepare the federal income tax return for Burr Corporation and resolve doubt in favor of his client if he believes there is reasonable support for his position. Burr gave an explanation for the difference between the bank deposits and sales and the CPA can determine the validity of these explanations. The idea that expenses seemed rather large is vague and the CPA should determine the reasonableness of the data furnished to him by the client. As prior years' tax returns were prepared on the accrual basis the CPA should obtain information on year-end adjustments from the client.

Burr's relating the fee proposal to the amount of tax liability creates a special ethical problem. The fee for professional accounting service cannot be contingent upon a CPA's findings unless the findings are those of tax authorities and not those of the CPA. The CPA should accept as his fee an amount equal to the value of his services and his fee should not by affected by the results of his findings in the engagement.

2. Yes. A CPA must sign the preparer's declaration on any federal tax return he prepares unless his service is mechanical, such as typing or duplicating a return prepared by the client. The CPA must sign the preparer's declaration even though he obtained the information from Burr rather than taking it directly from Burr Corporation's books.

3. A CPA's signature as the preparer of an income tax return implies that the CPA has examined the return, including all accompanying schedules and statements, and to the best of his knowledge and belief, based on all information of which he has any knowledge, is true, correct and complete. The CPA's signature on the federal income tax return does not imply that he made an examination of the underlying, supporting evidence as does the signature accompanying an opinion in his report on financial statements.

b. 1. A CPA who prepares unaudited statements on his own stationery should clearly and conspicuously mark each page as unaudited and disclaim an opinion to indicate to readers of the financial statements that he did not make an examination and therefore cannot express an opinion on them. Because the statements are unaudited, the CPA cannot be expected to have an opinion as to whether the statements were prepared in conformity with generally accepted accounting principles. However, if the CPA concludes on the basis of the facts known to him that unaudited statements which he is asked to prepare for the creditor may not be in conformity with generally accepted accounting principles or may not include adequate disclosure, he should prepare the statements with such revisions as he believes necessary for a fair presentation. If the client insists that the statements be prepared solely on the basis of the data furnished, the CPA should set forth clearly any reservations he may have in his disclaimer of opinion. The disclaimer should refer specifically to the nature of his reservations and to the effect, if known to him, on the financial statements. If the client will not agree to the appropriate revision or will not accept the CPA's disclaimer of opinion with any reservations clearly set forth, the CPA should withdraw from the engagement. The CPA should refuse to type, reproduce or become associated in any way with statements prepared by the client which, on the basis of facts known to him, he concludes are false or intended to mislead.

2. The CPA should render a disclaimer of opinion and clearly and conspicuously mark each page as unaudited in preparing "plain paper" unaudited financial statements with which his name is associated. The CPA would be associated with Burr Corporation's financial statements and should observe the same standards he would observe in preparing unaudited financial statements on his own stationery. Accordingly, the CPA should mark each page as unaudited and disclaim an opinion, require any adjustments he believes necessary or state his reservations in his disclaimer, and withdraw from the engagement if the client will not agree to these conditions or if the CPA believes the financial statements are false or misleading.

Answer 6

a. 1. The functions of audit working papers are to aid the CPA in the conduct of his work and to provide support for his opinion and his compliance with auditing standards.

2. Working papers are the CPA's records of the procedures followed, tests performed, and conclusions reached in his examination. Working papers may include work programs, analyses, memoranda, letters of confirmation and representation, abstracts of company documents and schedules or commentaries prepared or obtained by the auditor.

b. The factors that affect the CPA's judgment of the type and content of the working papers for a particular engagement include:

1. The nature of the auditor's report.
2. The nature of the client's business.
3. The nature of the financial statements, schedules or other information upon which the CPA is reporting and the materiality of the items included therein.
4. The nature and condition of the client's records and internal controls.
5. The needs for supervision and review of work performed by assistants.

c. Evidence which should be included in audit working papers to support a CPA's compliance with generally accepted auditing standards includes:
   1. Evidence that the financial statements or other information upon which the auditor is reporting were in agreement or reconciled with the client's records.
   2. Evidence that the client's system of internal control was reviewed and evaluated to determine the extent of the tests to which auditing procedures were restricted.
   3. Evidence of the auditing procedures followed and testing performed in obtaining evidential matter for evaluation.
   4. Evidence of how exceptions and unusual matters disclosed by auditing procedures were resolved or treated.
   5. Evidence of the auditor's conclusions on significant aspects of the engagement with appropriate commentaries.

d. The CPA should perform an adequate examination at minimum cost and effort and the preceding year's audit programs will aid him in doing this. The preceding year's audit programs ordinarily contain information useful in the current examination (such as descriptions of the unique features of a client's operations or records, a formalized sequence of audit steps in logical order, and approximate time requirements to perform various phases of the work).

   The CPA should review the old programs for current applicability and then decide based on the extent of changes required and the volume of material in the program whether he will find it more efficient to insert the programs in his current working papers for reuse or to write new programs for the current examination.

e. The client must keep records which can be audited or the CPA will be unable to complete his examination and issue an opinion on the financial statements. If the CPA believes that changes in record keeping are contemplated which will necessitate a considerably higher audit cost or create other serious problems for the client, he should discuss this with the client. The client is free to maintain records which are best suited to meet his own needs so long as he meets the minimum requirements of regulatory bodies. The CPA must find an alternative method of satisfying himself when a record he formerly reviewed has been discontinued.

Answer 7

Braun Corporation
WORKSHEET TO ADJUST OR RECLASSIFY ENTRIES TO TRADE NOTES RECEIVABLE
For the Year Ended December 31, 1968

					Adjustment Or Reclassification Required					
			Trade Notes Receivable		*Trade Notes Receivable*	*Trade Accounts Receivable*	*Interest Income*	*Other Accounts*		
								Account Title	*Amount*	
Date 1968		*Folio*	*Debit*	*Credit*	*Debit-(Credit)*	*Debit-(Credit)*	*Debit-(Credit)*		*Debit*	*Credit*
Jan. 1	Balance forward		$118,000							
Feb. 29	Received $25,000 6% note due 10/29/68 from Daley whose trade account was past due	Memo			$25,000	$(25,000)				
Feb. 29	Discounted Daley note at 6%	CR		$ 24,960	24,960		$ 40	Notes receivable discounted		$25,000
Mar. 29	Received non-interest bearing demand note from Edge, the Corporation's treasurer, for a loan	CD	6,200		(6,200)			Note receivable—officer	$ 6,200	
Aug. 30	Received principal and interest due from Allen and, in accordance with agreement, 2 principal payments in advance	CR		34,200	4,200		(2,800)	Accrued interest receivable		1,400
Sept. 4	Paid protest fee on note dishonored by Charnes	CD	5		(40,005)	41,605	(1,600)			
Nov. 1	Received check dated 2/1/69 in settlement of Bailey note. The check was included in cash on hand 12/31/68	CR		8,120	120	8,000	(480)	Accrued interest receivable Unearned interest income Cash on hand	80 400 	 8,120

Answer 7 (continued)

Braun Corporation
WORKSHEET TO ADJUST OR RECLASSIFY ENTRIES TO TRADE NOTES RECEIVABLE
For the Year Ended December 31, 1968

					Adjustment Or Reclassification Required					
			Trade Notes Receivable		*Trade Notes Receivable*	*Trade Accounts Receivable*	*Interest Income*	*Other Accounts*		
Date 1968		*Folio*	*Debit*	*Credit*	*Debit-(Credit)*	*Debit-(Credit)*	*Debit-(Credit)*	*Account Title*	*Amount Debit*	*Amount Credit*
Nov. 4	Paid protest fee and maturity value of Daley note to bank. Note discounted 2/29/68 was dishonored	CD	26,031		(51,031)	26,031		Note receivable discounted	25,000	
Dec. 27	Accepted furniture and fixtures with a fair market value of $24,000 in full settlement from Daley	GJ		24,000	24,000	(26,031)		Allowance for bad debts	2,031	
Dec. 31	Received check dated 1/3/69 from Edge in payment of 3/29/68 note. (The check was included in petty cash until 1/2/69 when it was returned to Edge in exchange for a new demand note of the same amount)	CR		6,200	6,200			Petty cash		6,200
Dec. 31	Received principal and interest on Charnes note	CR		42,437	42,437	(41,605)	(832)			
Dec. 31	Accrued interest on Allen note	GJ	1,200		(1,200)		400	Accrued interest receivable	800	
	Totals		$151,436	$139,917	$28,481	$(17,000)	$(5,272)		$34,511	$40,720

COMMERCIAL LAW

May 9, 1969; 8:30 a.m. to 12:00 m.

Answer 1

1. False
2. True
3. True
4. True
5. True
6. True
7. False
8. False
9. False
10. True
11. True
12. False
13. False
14. False
15. True
16. False
17. True
18. True
19. False
20. False
21. True
22. False
23. False
24. True
25. True
26. True
27. True
28. True
29. False
30. False

Answer 2

31. True
32. True
33. False
34. False
35. True
36. True
37. True
38. True
39. False
40. True
41. True
42. False
43. True
44. True
45. False
46. False
47. True
48. False
49. False
50. False
51. False
52. False
53. False
54. False
55. True
56. True
57. False
58. False
59. False
60. True

Answer 3

61. False	71. False	81. False
62. False	72. False	82. False
63. True	73. False	83. False
64. False	74. False	84. True
65. False	75. False	85. True
66. True	76. True	86. True
67. True	77. True	87. False
68. False	78. False	88. False
69. True	79. False	89. True
70. False	80. True	90. True

Answer 4

a. Bridge Builders intended to create a bilateral contract. Bridge Builders requested Allied Steel to agree "to promise to deliver" in exchange for its promise to pay the present market price for the goods ordered. A contract is bilateral if there are mutual promises whereas it is unilateral if the offeror's promise is made in exchange for performance by the offeree. Here the offeror's promise is offered in exchange for a promise from the offeree.

b. For an agreement to constitute a valid contract there must be:

1. *An offer and an acceptance.* These were present under the facts. Bridge Builders made a valid offer and informed Allied Steel that "as in the past" silence would be treated as an acceptance. Although silence is not usually treated as an acceptance, it would be so treated in this case because (i) the previous dealings between the parties established this mode of acceptance and (ii) later correspondence from Allied Steel showed that it had intended its silence to amount to acceptance, i.e., Allied Steel indicated that it had intended to deliver and that it had an obligation.
2. *Sufficient consideration.* The mutual exchange of promises in the letters constitutes the required consideration in this situation.
3. *Valid Subject Matter and Legal Capacity of the Parties.* The subject matter was valid and each of the parties had apparent legal capacity to contract.
4. *Satisfaction of the Statute of Frauds.* In that the dollar value of the contract for the sale of pipe is obviously in excess of $500 the Statute of Frauds applies. It would appear that the letter dated September 25, 1968 is a writing sufficient to statisfy the Statute of Frauds.

c. No. Allied Steel's mistake in shipping its last supply of pipe which it was holding for Bridge Builders to another customer amounted to no more than a unilateral mistake which would not serve as a ground for excusing failure of performance. Similarly the fact that it is financially impractical for Allied Steel to produce additional pipe for two months causes a subjective impossibility, which would generally not excuse performance (particularly since it was created by Allied Steel's unilateral mistake) as opposed to an objective impossibility (e.g., death or prohibiting legislation) which would excuse performance.

d. The question at issue would be whether the doctrine of substantial performance would apply. Under older common law cases an express contract had to be completed to the last detail to enforce payment. Under the newer concept of substantial performance payment may be demanded if (i) there was a substantial performance of the contract, (ii) there was an honest effort to comply fully, (iii) there was no willful or intentional departure from the terms of the contract, (iv) the deviations were minor, and (v) the performing party is willing to deduct from the contract price the amount, if any, of the damage sustained. On the above facts the doctrine of substantial performance would appear to be applicable. If the doctrine of substantial performance were applied by the court Bridge Builders would not be able to collect damages from Allied Steel for its failure to deliver "Allied Brand" steel pipe because no real damage would be incurred by Bridge Builders in using a comparable competitive brand.

Answer 5

Part a. 1. Even though it is a breach of the agreement which is not excused under the provisions of the Uniform Partnership Act, a partner may dissolve a partnership at any time. Scanon cannot force Orand to continue as a partner against his will. Regardless of the terms of the partnership agreement the right of withdrawal is an inseparable incident to every partnership and there can be no such thing as an indissolvable partnership. If a partner is withdrawing from a partnership in breach of partnership agreement the remaining partner may have an action for breach of contract. Here, however, it can be argued that Scanon's accepting a full-time job is an action which is tantamount to his dissolving the partnership as he is no longer available to serve the partnership. Scanon's actions would permit a court to infer that he intended to dissolve the partnership or to decree that he failed to act properly and therefore gave Orand cause to move for a judicial dissolution of the partnership.

2. In order to ensure a fair winding up of the partnership a court action for dissolution can be commenced and a court decree ordering the dissolution obtained. In such an action, if necessary, to ensure a fair winding up of the partnership the court will order and approve an accounting, impress a trust on partnership assets, demand that partnership records be produced and appoint a receiver.

3. If in the course of dissolving the partnership Scanon attempts to have a court invoke the contract provision which bars a partner attempting to unilaterally dissolve the partnership from ever again selling insurance, in addition to the argument that he was justified in his action Orand could attack the validity of the clause. The validity of such a restrictive clause would be dependent on the reasonableness of its provisions. The clause prohibiting selling insurance forever in the United States seems patently unreasonable, unjust, oppressive and bound to offend public policy.

Part b. 1. No. Watson merely delegated his duty to satisfy his potential liability to creditors to Malloy. As a result he in effect became a surety, i.e., he must perform in the event Malloy does not. To effectively eliminate his liability he would have to obtain a release from the existing creditors thereby constituting a novation.

2. Yes. Malloy's promise to assume Watson's share of the then existing firm liabilities is enforceable by the creditors despite the fact he did not directly make the promise to them or receive any consideration from them. They are third party beneficiaries of the Malloy-Watson promise and therefore have the requisite standing to sue. In the absence of an agreement to assume existing liabilities prior creditors are limited to resorting to an incoming partner's capital in the partnership for satisfaction of their claims.

3. Yes. Any change in the composition of the membership in the partnership constitutes a dissolution. A dissolution will occur despite the fact that the partnership affairs are not wound up.

Answer 6

a. 1. Unless so specified a lease for a term of years does not terminate upon the death of the tenant prior to the expiration of the term. The lessee's estate remains liable on the covenants in the lease for the payment of rent.

2. The fact that a lessor attempts to relet the premises after the abandonment of possession by a tenant is not sufficient in and of itself to constitute acceptance of a surrender of the rented space as a matter of law even though such attempts are accompanied by the posting of a "for rent" sign. A surrender of rental premises occurs "by operation of law" when the conduct of the parties is so incompatible with the terms of the lease or so inconsistent with the relation of landlord and tenant to indicate that both the landlord and the tenant (or the tenant's executor under the above facts) agreed to consider the surrender as having been made. The surrender by operation of law results from acts which imply mutual consent that both of their acts shall have the effect of creating a surrender. In determining the existence of a surrender by law the intent of the parties is the important point. Surrender will not be implied against the intent of the parties as manifested by their acts. Without additional facts evidencing an intent on the part of the landlord to consider the lease ended the attempt to relet the vacant premises to mitigate damages would not be considered adequate evidence of an intent to accept a surrender.

3. Security required under the provisions of a lease is security for the lessee's payment of rent or for his performance of the various stipulations or covenants contained in the lease. Unless it is specifically agreed, the security tendered by the lessee does not represent the maximum amount for which the lessor may hold him responsible if the lessee breaches the terms of the lease.

b. The remedy called "distress for rent" would allow a landlord to control a lessee's furniture until rent in arreárs is paid. In a jurisdiction where this type of remedy is still available a landlord may seize movables found on rented premises when rent is in arrears and hold them until the rent due is paid. Where the remedy of distress for rent is no longer available the landlord would not have any right to retain the tenant's goods or to hinder him from removing them from the premises and the landlord's only remedy would be to bring an action for payment of the rent.

c. If the executor sublets the premises pursuant to the terms of the lease and recognizes his obligation under the lease, the lease remains in effect and the tenant (the estate) remains responsible to the landlord under the lease, owes all rent due under the lease and is entitled to all of the rights of a tenant, including the return of security at the termination of the lease. The subtenant receives from the executor the right to occupy the premises for a shorter term than the full term of the lease. Rent of $250 per month is paid by the subtenant to the executor. If the executor parted with his full interest in the lease there would be an assignment of the lease rather than a subleting. If an assignment took place the assignee would become directly liable to the original landlord. In a sublet the executor retains a reversionary interest in the lease, the landlord must look to the executor for payment of the original amount due under the lease and, in absence of a statutory right, cannot enforce payment of rent by the subtenant. If the subtenant should fail to meet a payment of rent due or wrongfully terminate tenancy prior to the end of its terms the executor remains liable to the landlord under the terms of the lease.

Answer 7

1. There is a split of authority on the question raised by the facts. The older statutory rule, which apparently still prevails in many jurisdictions, is that a pre-incorporation subscription is an offer to purchase the shares of a corporation. As such, it may be withdrawn at any time prior to acceptance by the corporation. The earliest possible time of acceptance is at the time the corporation comes into existence. Since the subscriptions were withdrawn prior to incorporation the subscribers have effectively negated any liability on their part. Thus, under this approach, the bondholders would not be able to benefit from the subscribers' failure to take the shares to which they subscribed.

   The newer statutes, including the Model Business Corporation Act, make pre-incorporation subscriptions irrevocable for a stated period of time, typically six months. Since this period has expired and apparently no stock was issued to the withdrawing subscribers, they have no liability. Thus, the bondholders would not be able to benefit by the withdrawal of the subscriptions.
2. Shareholders who do not contribute an amount at least equal to the par value of the stock issued are liable to creditors. The extent of liability is the difference between the par value and the amount actually contributed. The bondholders as creditors can seek to have this amount paid to the corporate

treasury or, in the event of dissolution and a deficiency, paid to them to satisfy their claims.

3. It is illegal for directors to pay dividends out of the legal capital of a corporation. Most states either make the stockholders return the dividend or hold the directors personally liable for such an act. The bondholders may seek to have the stockholders or directors repay that part of the dividend which impaired Bullock Corporation's legal capital.
4. The facts clearly indicate a breach of the fiduciary duty by the director. As a result the director may be held accountable to the Corporation for the profits he has wrongfully received and he may be required to convey the patent to the Corporation at the price he paid for it.
5. The possibility raised by the facts is that Bullock Corporation does not legally exist. That is, it has attained neither *de jure* nor *de facto* status due to the irregularities in its incorporation. Although the defects are relatively minor and would probably not prevent *de facto* status, it is a point worth exploring. If the Corporation has not attained *de facto* status the stockholders would have personal liability as partners. Thus the bondholders could obtain payment from the "partners" in the event corporate assets were insufficient to satisfy their claims.

Answer 8

a. 1. CPAs as members of a learned and skilled profession are obligated to exercise reasonable care and be competent in their undertakings. Failure to live up to the above standards constitutes negligence and the CPA may be held liable to his client for the damages resulting from the negligence.

Since Jackson Financial was the client they have the proper standing to sue and recover for the loss proximately caused by the negligent performance of the engagement. It would appear that Jackson Financial could also recover the fee as damages because of Williams' breach of contract.

2. The first argument which Williams' attorney would make is that his liability for negligence does not extend beyond his client. Apex was not a party to the contract and the audit was not intended for its benefit. Thus, in the absence of fraud, a CPA may generally not be held liable for ordinary negligence to third parties. There is little authority on the precise question raised by the facts in the problem. The chief distinguishing factor in this case is the fact that although the party suing is neither a client nor an intended beneficiary, it is the company whose financial statements were examined. Whether this fact creates a duty of care owed to Apex is at present unclear.

The second argument which undoubtedly would be made is that Apex was in some way contributorily negligent. Normally where both parties are negligent recovery is denied.

Finally, it might be argued that the examination, at least to some extent, was not casual. This is undoubtedly so, at least as to the funds misappropriated prior to the engagement, since even a non-negligent examination would not have prevented the loss.

3. No. A CPA is not prevented from recovering against his insurer. This is precisely the purpose which this type of insurance serves, i.e., to protect the insured from his own negligence.

b. 1. Martin's attorney would claim that since the subpoenaed evidence was between a CPA and his client it is privileged communication. As such it should be excluded. The basis for this rule is the confidential relationship between the parties.

2. Only a minority of jurisdictions in the United States have changed the common law rule which denies the existence of privilege between a CPA and his client. Thus, in those states where no privilege exists the evidence will be admitted over the objection of Martin's attorney. Where there is a state law which creates such a privilege, the confidential communications between an accountant and his client are not admissible in evidence so long as the privilege is properly asserted on the client's behalf.

3. The working papers supporting the work performed are the property of the CPA. Not even the client has a right to obtain them unless the CPA agrees to relinquish them. The CPA's ownership is restricted or custodial in nature for the purpose of permitting him to retain the working papers as evidence of the nature and extent of the services rendered by the CPA. However, such ownership does not constitute grounds, at common law, for refusing to produce the working papers nor testifying with respect to their contents when required by legal process.

THEORY OF ACCOUNTS

May 9, 1969; 1:30 p.m. to 5:00 p.m.

Answer 1

1. c	11. c
2. a	12. c
3. b	13. d
4. a	14. d
5. c	15. a
6. b	16. c
7. d	17. a
8. d	18. d
9. c	19. d
10. b	20. a

Answer 2

a. Earnings per share, as it applies to a corporation with a capitalization structure composed of only one class of common stock, is the amount of earnings applicable to each share of common stock outstanding during the period for which the earnings are reported. The computation of earnings per share should be based on a weighted average of the number of shares outstanding during the period with retroactive recognition given to stock splits or reverse splits and to stock dividends, except relatively small nonrecurring stock dividends may be ignored. The computation should be made for income before extraordinary items, extraordinary items net of income tax, and net income. The earnings per share from each of the foregoing should be presented in the income statement and it is desirable that the method of computation be disclosed.

b. Meanings of terms often used in discussing earnings per share and the types of items to which they apply follow:

1. Senior securities are securities which have preference to earnings before earnings are allocated to common stock. Cumulative preferred dividends whether or not earned should be deducted from net income except "if earned" dividends should be deducted only to the extent earned. Preferred stock is a senior security if it has a preference on dividends. Bonds are a senior security which enter into the determination of net income.
2. For purposes of computing earnings per share residual securities are those securities deriving a major portion of their value from their right to be converted into common stock through the exercise of an option or conversion privilege by the owner of the security. Convertible preferred stock, convertible debt, common stock options and common stock warrants are examples of such securities.

c. Treatments to be given to the listed items in computing earnings per share are:

1. Dividends on preferred stock should be deducted from net income and also net income before extraordinary items before computing earnings per share applicable to the common stock and other residual securities. If the preferred stock is cumulative this adjustment is appropriate whether or not the amounts of the dividends are declared or earned.
2. Minor reacquisitions of outstanding common stock which is placed in the treasury may be excluded in the computation of earnings per share. However, in determining earnings per share during the period when a major acquisition of treasury common stock was made, the computation should be based on the weighted average number of shares outstanding during the period.
3. When the number of common shares outstanding increases as a result of a stock split during the year, the computation should be based on shares outstanding at year end and retroactive recognition should be given for an appropriate number of prior years.
4. The existence of a provision for a contingent liability on a possible lawsuit created out of retained earnings will not affect the computation of earnings per share since the appropriation of retained earnings does not affect net income or the number of shares of stock outstanding.
5. Outstanding preferred stock with a par value liquidation right issued at a premium, although affecting the determination of book value, will not affect the computation of earnings per share for common stock except with respect to the dividends as discussed in c. 1. above.
6. The exercise of a common stock option which results only in a minor increase in the number of shares outstanding during the period may be disregarded in the computation of earnings per share. If, however, the exercise of a common stock option results in a major increase in the number of shares outstanding, the computation of earnings per share should be based on the weighted average number of shares outstanding during the period. The exercise of a stock option by the grantee does not affect earnings, but any compensation to the officers from the granting of the options would reduce net income and earnings per share.

7. The replacement of a machine immediately prior to the close of the current fiscal year will not affect the computation of earnings per share for the year in which the machine is replaced. The number of shares remains unchanged and since the old machine was sold for its book value, earnings are unaffected.

Answer 3

Part a. Generally accepted accounting principles are ordinarily concerned only with a "fair presentation" of business income. In contrast, taxable income is a statutory concept which defines the base for raising tax revenues by the government, and any method of accounting which meets the statutory definition will "clearly reflect" taxable income as defined by the *Internal Revenue Code*. It should be noted that the *Code* prohibits use of the cash receipts and disbursements method as a method which will clearly reflect income in accounting for purchases and sales if inventories are involved.

The cash receipts and disbursements method will not usually fairly present income because:

(1) The completed transaction, not receipt or disbursement of cash, increases or diminishes income. Thus a sale on account produces revenue and increases income and the incurrence of expense reduces income without regard to the time of payment of cash.

(2) The matching principle requires that costs be matched against related revenues produced. In most situations the cash receipts and disbursements method will violate the matching principle.

(3) Consistency requires that accountable events receive the same accounting treatment from accounting period to accounting period. The cash receipts and disbursements method permits manipulation of the timing of revenues and expenses and may result in treatments which are not consistent, detracting from the usefulness of comparative statements.

Part b. The income tax concept known as the "claim of right" doctrine decrees that a taxpayer realizes income and must report it at the time of receipt when cash is received for future benefits or services, provided the taxpayer enjoys the unrestricted use of the cash and has only a contingent liability to repay the amount received.

Part c. 1. For financial accounting purposes the payment by a cash basis taxpayer of a \$3,600 advance rental would be recorded as an asset at the time of payment. To record the payment as an expense would be in violation of generally accepted accounting principles (except when used in fund accounting) and is inappropriate except in reporting cash flow.

The receipt by an accrual basis taxpayer of a \$3,600 advance rental payment would be recorded as unearned revenue for financial accounting purposes and treated as a liability until earned.

2. For income tax reporting purposes the payment of a \$3,600 advance rental would be reported as an asset by a cash basis taxpayer and the receipt would be reported as earned revenue by an accrual basis taxpayer.

   Because the \$3,600 payment creates an asset with a life substantially in excess of one year the cash basis taxpayer could deduct no more than \$1,200 in any year $\left(\frac{\$3,600 \times 12}{36}\right)$ for income tax reporting purposes as specified in Regulation 1-461-1(a).

   Because Regulation 1.61-8(b) specifies that gross income includes gross rentals which must be included in income for the year of receipt regardless of the period covered or the method of accounting employed by the taxpayer, an accrual basis taxpayer would have to include the entire \$3,600 in income in the year of receipt for income tax reporting purposes. It should be pointed out, however, that, by statute and court decisions, some other types of items of unearned revenues are allowed to be apportioned over the period in which they are earned by an accrual basis taxpayer who can show that a reasonable method of apportionment is used, e.g., magazine subscriptions and organization dues.

Answer 4

a. It is considered desirable to present a statement of source and application of funds as supplementary information in financial reports because such information is useful for a variety of purposes affecting both operating and investment decisions. A statement of source and application of funds is helpful because it presents information which cannot easily be obtained from the financial statements and because it presents articulated information about the movement of funds. While a statement of source and application of funds cannot supplant the income statement, it can provide a useful and significant summary of certain transactions. The statement of source and application of funds is particularly helpful in appraising financial policies of the past and in planning financial activities of the future.

b. 1. When the funds concept denotes cash, all non-cash balance sheet changes are analyzed in terms of their effect upon the movement of cash. Under the cash concept of funds flow analysis the statement of source and application of funds is designed to explain the sources and uses of cash.

   Cash flow can be more precisely measured than can other concepts of funds because the valuation problems of cash are not as great as for other financial resources. However, movement of cash may be easily influenced. For example payments of liabilities may be temporarily delayed or marketable securities may be sold, increasing cash flow for a given period.

2. Net monetary assets are defined as the quick current assets, i.e., cash, accounts receivable, and marketable securities, less current liabilities. Thus

a statement of source and application of funds prepared under the net monetary assets concept of funds flow analysis reports the changes in all non-quick current assets and non-current liabilities in terms of their effect upon the movement of net monetary assets.

Under the net monetary assets concept of funds, the problem of valuation for marketable securities and accounts receivable arises. As a result precision in the measurement of funds flow is decreased. While selected alternatives are available which may influence the movement of net monetary assets, such as the temporary postponement of inventory purchases, the range of possibilities is not as great as for cash movements. For example selling marketable securities or postponing the payment of current liabilities will not influence the flow of net monetary assets.

3. Working capital is defined as current assets less current liabilities. A statement of source and application of funds prepared under the working capital concept of funds flow analysis reports the changes in the non-current accounts which affect the movement of current items.

The working capital concept of funds enlarges the problem of valuation because it includes inventory and prepaid items. Thus the measurement of working capital flows is less precise than for cash or net monetary assets. However, this concept further reduces the areas for window dressing. For example, the postponement of the purchase of merchandise on open account will not influence working capital flows.

c. Weaknesses in presentation and disclosure of Clovis Company's Statement of Source and Application of Funds include the following:

Date. The date of the statement should indicate the time period covered by the statement.

Arrangement. As the major recurring activity of the firm is operations, it is recommended practice to report as the first item in a statement of source and application of funds resources provided by operations with the related adjustments for non-fund items such as depreciation and amortization, deferred income taxes, and gains and losses on the disposition of non-current assets.

As an alternative arrangement, gross inflows of funds from operations could be reported with a deduction for operating expenses requiring the use of funds. Under this alternative non-fund items such as depreciation and amortization, deferred income taxes, etc., would not appear on the statement. Abnormal operating revenues or expenses should be separately stated. Extraordinary gains and losses should not be reported, but rather should be included in the funds provided (if any) by the extraordinary event.

Research and development expenditures. In order to reflect accurately the funds provided by normal operations, the deduction for abnormal research and development expenditures should be excluded from the computation of funds provided by operations and reported separately as an application.

Depreciation and amortization. Depreciation and amortization should be reported as an adjustment to net income which did not require the use of funds. As presented, it erroneously implies that depreciation and amortization were sources of funds.

Deferred income taxes. Like depreciation and amortization, deferred income taxes relating to accelerated depreciation should be reported also as an adjustment to net income which did not require the use of financial resources during the period.

Gain on sale of equipment. The $3,000 gain on the equipment sale should be deducted as an adjustment to net income. The actual funds provided by the sale should be reported as $8,000.

Acquisition of future plant site. To achieve improved clarity in reporting, the acquisition of future plant site should be separated into its two components—the portion donated by the City of Camden and the portion acquired through the use of corporate funds.

An acceptable but less desirable alternative is to report the donation of plant site by the City of Camden as follows:

Funds were applied to:

Acquisition of future plant site (Note 1)	$250,000	
Less portion donated by the City of Camden	115,000	$135,000

Disclosure. The footnotes do not disclose commitments to use funds in the future or contractural rights to funds available but not executed in 1968.

Answer 5

a. 1. Cost is the amount measured by the current monetary value of economic resources given up or to be given up in obtaining goods and services. Economic resources may be given up by transferring cash or other property, issuing capital stock, performing services, or incurring liabilities.

Costs are classified as unexpired or expired. Unexpired costs are assets and apply to the production of future revenues. Examples of unexpired costs are inventories, prepaid expenses, plant and equipment, and investments. Expired costs, which most costs become eventually, are those that are not applicable to the production of future revenues and are deducted from current revenues or charged against retained earnings.

2. Expense in its broadest sense includes all expired costs, i.e., costs which do not have any potential future economic benefit. A more precise definition limits the use of the term expense to the expired costs arising from using or consuming goods and services in the process of obtaining revenues, e.g., cost of goods sold and selling and administrative expenses.

3. A loss is an unplanned cost expiration and for this reason is often included in the broad definition of expenses. A more precise definition restricts the use of the term loss to cost expirations which do not benefit the revenue-producing activities of the firm. Examples include the unrecovered book value on the sale of fixed assets and the write-off of goodwill due to unusual events within an accounting period.

The term loss is used also to refer to the amount by which expenses and extraordinary items exceed revenues during an accounting period.

b. 1. Cost of goods sold is an expired cost and may be referred to as an expense in the broad sense of the term. On the income statement it is most often identified as a cost. Inventory held for sale which is destroyed by an abnormal casualty should be classified as a loss.

2. Bad debts expense is usually classified as an expense. However, some authorities believe that it is more desirable to classify bad debts as a direct reduction of sales revenue (an offset to revenue). A material bad debt which was not provided for in the annual adjustment, such as bankruptcy of a major debtor, may be classified as a loss.
3. Depreciation expense for plant machinery is a component of factory overhead and represents the reclassification of a portion of the machinery cost to product cost (inventory). When the product is sold, the depreciation becomes a part of the cost of goods sold which is an expense. Depreciation of plant machinery during an unplanned and unproductive period of idleness, such as during a strike, should be classified as a loss. The term expense should preferably be avoided when making reference to production costs.
4. Organization costs are those costs that benefit the firm for its entire period of existence and are most appropriately classified as a non-current asset. When there is initial evidence that a firm's life is limited the organization costs should be allocated over the firm's life as an expense, or amortized as a loss when a going concern foresees termination.

   In practice, however, organization costs are often written off in the early years of a firm's existence.
5. Spoiled goods resulting from normal manufacturing processing should be treated as a cost of the product manufactured. When the product is sold the cost becomes an expense. Spoiled goods resulting from an abnormal occurrence should be classified as a loss.

c. Period costs and product costs are usually differentiated under one of two major concepts. One concept identifies a cost as a period or a product cost according to whether the cost expires primarily with the passage of time or directly for the production of revenue. The other concept identifies a cost as a product or a period cost according to whether or not the cost is included in inventory.

Under the first concept period costs are all costs which expire within the accounting period and are only indirectly related to the production of revenue within the period and product costs are those costs associated with the manufacture of a firm's product and that generate revenue in the period of its sale. Some costs are easily associated with the production of revenue, such as the manufacturing or purchase cost of a product sold, and are designated as product costs. Other costs may be incurred as costs of doing business and are more difficult to relate to the production of revenue, such as general and administrative costs, and are classified as period costs. Costs which cannot be readily identified with the production of revenue in any particular period, such as the company president's salary which may produce revenue in many distant future accounting periods, are also classified as period costs because they cannot be specifically identified with any future accounting period.

Under the second concept product costs include only the costs which are carried forward to future accounting periods in inventory and all expired costs are period costs.

Answer 6

a. 1. The theoretical justification for accrual recognition of pension costs is based in the matching concept. Pension costs are incurred during the period over which an employee renders his services to the enterprise; these costs may be paid upon the employee's retirement, over a period of time after retirement, as incurred through funding or insurance plans, or through some combination of any or all of these methods.

2. Although cash (pay-as-you-go) accounting is highly objective for the final determination of actual pension costs, it provides no measurement of annual pension costs as they are incurred. Accrual accounting provides greater objectivity in the annual measurement of pension costs than does cash accounting if actuarial cost methods are applied to actuarial valuations to determine the provision for pension costs. While cash accounting provides a more precise determination of the final cost, accrual accounting provides a more objective measure of the annual cost.

b. Terms and their definitions as they apply to accounting for pension plans follow:

1. An actuarial valuation of a pension plan is the process used by actuaries for determining the amounts an employer is to contribute (pay, fund) under a pension plan (except when an insured arrangement calls for payment of specified premiums). A valuation is made as of a specific date, which need not coincide with the end of the period for which a payment based on the valuation will be made.

   An initial step in making a valuation is to determine the present value on the valuation date of benefits to be paid over varying periods of time in the future to employees after retirement (plus any other benefits under the plan). An actuarial cost method is then applied to this present value to determine the contributions to be made by the employer. The resulting determinations are estimates, since in making a valuation a number of significant uncertainties concerning future events must be resolved by making several actuarial assumptions.

2. Actuarial cost methods have been developed by actuaries as funding techniques to be used in actuarial valuations. Many of the actuarial cost methods are also useful for accounting purposes. The principal methods which apply for accounting purposes are the unit credit method, the entry age normal method, the individual level premium method, the aggregate method and the attained age normal method.

3. Vested benefits are benefits that are not contingent on the employee's continuing in the service of the employer. In some plans the payment of the benefits will begin only when the employee reaches the normal retirement date; in other plans the payment of the benefits will begin when the employee retires (which may be before or after the normal retirement date). The actuarially computed value of vested benefits represents the present value, at the date of determination, of the sum of (a) the benefits expected to become payable to former employees who have retired, or who have terminated service with vested rights, at the date of determi-

nation; and (b) the benefits, based on service rendered prior to the date of determination, expected to become payable at future dates to present employees, taking into account the probable time that employees will retire, at the vesting percentages applicable at the date of determination. The determination of vested benefits is not affected by other conditions, such as inadequacy of the pension fund, which may prevent the employee from receiving the vested benefits.

c. The following disclosures about a company's pension plans should be made in financial statements or their notes:
   1. A statement that such plans exist, identifying or describing the employee groups covered.
   2. A statement of the company's accounting and funding policies.
   3. The provision for pension cost for the period.
   4. The excess, if any, of the actuarially computed value of vested benefits over the total of the pension fund and any balance-sheet pension accruals, less any pension prepayments or deferred charges.
   5. Nature and effect of significant matters affecting comparability for all periods presented, such as changes in accounting methods (actuarial cost method, amortization of past and prior service cost, treatment of actuarial gains and losses, etc.), changes in circumstances (actuarial assumptions, etc.), or adoption or amendment of a plan.

Answer 7

a. Contribution margin data are useful for
   1. Identifying products which should be retained or eliminated by making it possible to determine if a product is providing at least a short-run contribution to profits through recovery of more than its variable costs.
   2. Indicating which products to emphasize and which merely to provide because they indirectly contribute to the sale of more profitable products.
   3. Comparing added costs of alternative proposals to stimulate sales volume with prospective additions to sales.
   4. Determining the number of units which must be sold in order to achieve a given profit goal.
   5. Determining the maximum allowable variable cost and minimum volume of products of a firm in an industry with firmly established selling prices.
   6. Clarifying the relationship of cost, volume and profit in pricing decisions.
   7. Maximizing the total contribution to profit in product mix decisions involving a scarce resource.

b. 1. The capacity of the Cutting Department is represented graphically by the area on and beneath the line connecting points (0,200) and (400,0).
   2. The production limitation on gadgets, $G \leqq 180$ units per day, is represented graphically by the area on and beneath the line connecting points (0,180), (40,180) and (105,180).
   3. The area of feasible production combinations is the area on and bounded by the polygon formed by points (0,0), (0,180), (40,180), (144,128) and (240,0).

c. 1.

COMPUTATION OF CONTRIBUTION MARGIN PER UNIT FOR TRINKETS AND GADGETS

	Trinkets	*Gadgets*
Sales price per unit	$50	$70
Variable cost per unit	30	40
Contribution margin per unit	$20	$30

2.

COMPUTATION OF TOTAL CONTRIBUTION MARGIN FOR EACH OF THE FEASIBLE PRODUCTION ALTERNATIVES

Trinkets		*Gadgets*		
$20 (0)	+	$30 (0)	=	$ 0
20 (0)	+	30 (180)	=	5,400
20 (40)	+	30 (180)	=	6,200
20 (144)	+	30 (128)	=	6,720
20 (240)	+	30 (0)	=	4,800

3. By producing 144 trinkets and 128 gadgets the Corporation will maximize its total contribution margin when its scarce resource is productive capacity. Therefore, this production alternative is best.

Solutions and Answers to Examination November 1969

ACCOUNTING PRACTICE—PART 1

November 5, 1969; 1:30 to 6:00 p.m.

Solution 1

1. b	11. h	21. j	31. c
2. g	12. b	22. a	32. e
3. h	13. f	23. d	33. g
4. a	14. h	24. e	34. b
5. d	15. a	25. b	35. f
6. e	16. e	26. i	36. h
7. f	17. c	27. g	37. d
8. i	18. i	28. c	38. j
9. j	19. d	29. a	39. b
10. j	20. f	30. i	40. a

Solution 2

a. **Lang Manufacturing Company**

COMPUTATION OF TOTAL TAXABLE WAGES TO BE REPORTED ON 1968 PAYROLL TAX RETURNS

Year Ended December 31, 1968

Description	*Wages Taxable for F.I.C.A.*	*Wages Taxable for State Unemployment Tax*
1968 totals included in tax returns prepared by Lang*	$102,500	$59,000
Corrections:		
Add taxable wages charged to the Land and Buildings account	1,000	1,000
Deduct accrued payroll from wages taxable for F.I.C.A. (taxable when paid)	(1,200)	—0—**
Deduct contractor's fee included in wages	(2,300)	(2,300)
Net corrections to wages	(2,500)	(1,300)
Corrected 1968 taxable wages	$100,000	$57,700

*As indicated in the information given, gross wages reported on the tax returns ($121,800) agree with the general ledger expense accounts for wages.

**An amount, not determinable from the stated facts, should be deducted in those states which have a maximum taxable wage base for the state unemployment tax between $4,000 and $6,000.

b. **Lang Manufacturing Company**

COMPUTATION OF AMOUNTS TO BE PAID WITH PAYROLL TAX RETURNS TO BE FILED IN JANUARY 1969

For the Year Ended December 31, 1968

	F.I.C.A.	*Income Tax Withheld*	*State Unemployment Tax*	*Federal Unemployment Tax*
Total taxable wages for 1968 (from part "a")	$100,000		$57,700	$57,700*
Tax rate applicable thereto (includes employees' portion of F.I.C.A.)	× 8.8%		× 2.7%	× .4%
Total tax for 1968	$ 8,800		$ 1,558	$ 231
Income tax withheld from employees in 1968		$15,740		
Less amounts remitted with returns for first three quarters	7,790	11,490	1,394	
Balance—liability applicable to fourth quarter	1,010	4,250	164	
Less amounts paid to depositary for October and November	900	2,720		
Balance to be paid with tax returns filed in January 1969	$ 110	$ 1,530	$ 164	$ 231

*This amount will vary in those states which have a maximum taxable wage base for the state unemployment tax in excess of $3,000.

c. **Lang Manufacturing Company**

RECONCILIATION OF PAYROLL TAXES PAYABLE TO RELATED GENERAL LEDGER BALANCES

December 31, 1968

	Income Tax Withheld	*F.I.C.A.*	*State Unemployment Tax*	*Federal Unemployment Tax*
Balance to be paid with tax returns filed in January 1969 (from part "b")	$1,530	$110	$164	$231
Add adjustments of taxable wages (as computed in part "a"):				
F.I.C.A. $2,500 × 8.8%		220		
S.U.T. $1,300 × 2.7%			35	
F.U.T. $1,300 × .4%				5
Add employees' F.I.C.A. tax paid to depositary for October and November and charged to expense		450		
Add adjustment for using incorrect base for accruing F.U.T.—.4% × ($102,-500-$59,000)				174
Balance shown as liability in general ledger ($2,145 + $774 = $2,919) =	$1,530	$780	$199	$410

Summary of Composition of General Ledger Account Balances (not required)

	Total From Above	*Employees' Liability Account*	*Employer's Liability Account*
Income tax withheld	$1,530	$1,530	
F.I.C.A.	780	615	$165
State unemployment tax	199		199
Federal unemployment tax	410		410
Totals	$2,919	$2,145	$774

Solution 3

Major Electrical, Inc.

WORKSHEET TO DETERMINE PRO-FORMA OPENING ACCOUNT BALANCES

November 1, 1969

Account	Grover Hardware Trial Balance		Howard & Sanders Trial Balance		Grover Hardware Adjusting Entries		Howard & Sanders Adjusting Entries		Major Electrical, Inc. Opening Account Balances	
	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit
Cash	$ 17,000		$ 20,700		(2)$ 9,000			(5)$ 6,000	$ 40,700	
Accounts receivable	43,000					(A)$ 2,800	(1)$ 20,300		60,500	
Unbilled contract in progress							(1) 8,000		8,000	
Allowance for bad debts		$ 3,000						(3) 400		$ 3,400
Inventory	63,000		3,500					(2) 3,500	63,000	
Prepaid expenses	2,000		1,300				(3) 1,200		4,500	
Land, building and equipment	44,000		26,000						70,000	
Allowance for depreciation		27,000		$ 12,000						39,000
Goodwill					(3) 15,000		(6) 30,000		45,000	
Accounts payable		54,000					(A) 2,800	(2) 6,200		57,400
Accrued expenses payable		4,000						(3) 2,400		6,400
Deposit on contract				2,500						2,500
Grover, Capital		75,000			(2) 81,000	(1) 6,000				
Grover, Drawing	5,000					(1) 5,000				
Howard, Capital				11,300			(5) 32,000	(4) 20,700		
Sanders, Capital				7,700			(5) 22,000	(4) 14,300		
Revenues		200,000		70,000				(1) 28,300		
Cost of producing revenues	160,000		31,000				(2) 9,700			
Partners' salaries			7,000					(4) 7,000		
Operating expenses	29,000		14,000				(3) 1,600			
Totals	$363,000	$363,000	$103,500	$103,500						
Net income					(1) 11,000		(4) 42,000			
Preferred stock						(2) 90,000		(5) 48,000		138,000
Common stock						(3) 15,000		(6) 30,000		45,000
Elimination Total						$ 2,800	$ 2,800			
Totals					$116,000	$116,000	$166,800	$166,800	$291,700	$291,700

1. **Schedule (1)**

COMPUTATION OF CASH CONTRIBUTION AND DISTRIBUTION AND PREFERRED STOCK TO BE ISSUED

		Howard & Sanders		
Net Assets	*Grover*	*Recorded*	*Unrecorded*	*Total*
Cash	$17,000	$20,700		$20,700
Accounts receivable	43,000		$20,300	20,300
Unbilled contract			8,000	8,000
Allowance for bad debts	(3,000)		(400)	(400)
Inventory	63,000	3,500	(3,500)	
Prepaid expenses	2,000	1,300	1,200	2,500
Land, building & equipment	44,000	26,000		26,000
Allowance for depreciation	(27,000)	(12,000)		(12,000)
Accounts payable	(54,000)		(6,200)	(6,200)
Accrued expenses payable	(4,000)		(2,400)	(2,400)
Deposit on contract		(2,500)		(2,500)
Total net assets	$81,000	$37,000	$17,000	$54,000

		Partnership		
	Grover	*Howard*	*Sanders*	*Total*
Total net assets (above)	81,000	32,000*	22,000*	54,000
Preferred stock to be issued:				
900 shares @ $100 per share	90,000			
480 shares @ $100 per share		28,400**	19,600**	48,000
Cash to be contributed	9,000			
Cash to be distributed		3,600	2,400	6,000

*Computation of partner capital balances at October 31, 1969:

	Howard	*Sanders*	*Total*
Balance per books, January 1, 1969	11,300	7,700	19,000
Add net income— 10 months to October 31, 1969 per closing entry 4	20,700	14,300	35,000
	32,000	22,000	54,000

**Computation of allocation of preferred stock to Howard and Sanders:

Howard: 48,000 × (32,000 ÷ 54,000) = 28,400

Sanders: 48,000 × (22,000 ÷ 54,000) = 19,600

2. **Schedule (2)**

COMPUTATION OF SHARES OF COMMON STOCK TO BE ISSUED

	Grover	*Howard & Sanders*	*Total*
Average expected revenues	$600,000	$240,000	
Industry net income rate	.0135	.075	
Average industry net income	$ 8,100	$ 18,000	
Average expected earnings	$ 39,000	$ 55,500	
Deduct owners' salaries	15,000	21,000	
Expected earnings before taxes	24,000	34,500	
Income tax at 40%	9,600	13,800	
Average expected net income	14,400	20,700	
Average industry net income	8,100	18,000	
Annual excess earnings expected	6,300	2,700	
Five year period	5	5	
Total contribution in excess of industry average for 5 years capitalized as goodwill	$ 31,500	$ 13,500	$45,000
Average expected net income	$ 14,400	$ 20,700	
Lesser of average industry net incomes	8,100	8,100	
Amounts to determine allocation ratio	$ 6,300	$ 12,600	$18,900
Allocation of common stock:			
$\frac{\$\ 6,300}{\$18,900} \times \$45,000$	$ 15,000		
$\frac{\$12,600}{\$18,900} \times \$45,000$		$ 30,000	
Shares of common stock to be issued at $10 par value each	1,500	3,000*	

*The 3,000 shares of common stock allocated to Howard & Sanders should be issued in their profit and loss sharing ratio:

Howard (60%)	1,800 shares
Sanders (40%)	1,200 shares

Howard and Sanders Books

ADJUSTING AND CLOSING ENTRIES
(not required)

1969			
	(1)		
October 31	Accounts receivable	$ 20,300	
	Unbilled contracts in progress	8,000	
	Revenues		$ 28,300
	To accrue revenues representing outstanding billings on jobs completed and estimated value of unbilled contract in progress (80% of $10,000)		
	(2)		
October 31	Cost of producing revenues	9,700	
	Inventory		3,500
	Accounts payable		6,200
	To accrue costs of producing revenues and to write off inventory applicable to contract in progress		
	(3)		
October 31	Prepaid expenses	1,200	
	Operating expenses	1,600	
	Accrued expenses payable		2,400
	Allowance for bad debts		400
	To accrue expenses and estimated bad debts, and to record prepaid expenses		
	(4)		
October 31	Net income	42,000	
	Howard, Capital		20,700
	Sanders, Capital		14,300
	Salaries		7,000
	To close partnership net income for 10 months according to the following computations:		
	Net income to October 31, 1969 per books ($70,000—31,000—14,000)		$ 25,000
	Add adjustment to accrual basis ($28,300—9,700—1,600)		17,000
	Total net income		$ 42,000

Net income distributed:

	Howard	*Sanders*	*Total*
Salaries (10 months)	$10,000	$ 7,500	$ 17,500
Balance—P & L ratio	14,700	9,800	24,500
Total	24,700	17,300	42,000
Deduct: Salaries paid	(4,000)	(3,000)	(7,000)
Increase to capital accounts	$20,700	$ 14,300	$ 35,000

(4)—Alternate

(Additional closing entries not reflected on worksheet)

October 31	Income summary	$ 56,300	
	Cost of producing revenues		$ 40,700
	Operating expenses		15,600
	To close		
October 31	Revenues	98,300	
	Income summary		98,300
	To close		
October 31	Income summary	42,000	
	Howard, Capital		20,700
	Sanders, Capital		14,300
	Salaries		7,000
	To close		

(5)

October 31	Howard, Capital	32,000	
	Sanders, Capital	22,000	
	Preferred stock		48,000
	Cash		6,000
	To record closing of partners' capital accounts, distribution of 480 shares of preferred stock of Major Corporation, and cash settlement according to the agreement between the parties, and as determined in Schedule (1)		

(6)

October 31	Goodwill	30,000	
	Common stock		30,000
	To record the estimated value of goodwill and the issuance of 3,000 shares common stock ($10 par value) of Major Corporation therefor, according to the agreement between the parties, and as determined in Schedule (2)		

Grover Hardware Books

ADJUSTING AND CLOSING ENTRIES
(not required)

1969

(1)

October 31	Net income	$ 11,000	
	Grover, Capital		$ 6,000
	Grover, Drawing		5,000
	To close net income for 10 months		

(1)—Alternate

(Additional closing entry not reflected on worksheet)

October 31	Revenues	200,000	
	Cost of producing revenues		160,000
	Operating expenses		29,000
	Income summary		11,000
	To close		
October 31	Income summary	11,000	
	Grover, Capital		6,000
	Grover, Drawing		5,000
	To close		

(2)

October 31	Cash	9,000	
	Grover, Capital	81,000	
	Preferred stock		90,000
	To record issuance to Grover of 900 shares of preferred stock of Major Corporation, closing of the capital account, and cash paid in by Grover, according to the agreement between the parties, and as determined in Schedule (1)		

(3)

October 31	Goodwill	15,000	
	Common stock		15,000
	To record the estimated value of goodwill and the issuance of common stock of Major Corporation therefor, according to the agreement between the parties, and as determined in Schedule (2)		

Solution 4

a. 1. **SCHEDULE COMPUTING TOTAL OVERHEAD COST**

Employee	*Annual Salary*	*Percentage of Time Devoted to Firm Overhead*	*Salary Allocated To Overhead*
Able	$ 2,400	40%	$ 960
Briscol	12,000	10%	1,200
Case	8,000	20%	1,600
Dider	10,000	40%	4,000
Emel	7,200	5%	360
Total	$39,600		

Employees' salary allocated to overhead	8,120
Other overhead cost	39,100
Total overhead cost	$47,220

2. **SCHEDULE COMPUTING TOTAL EMPLOYEES' SALARY DIRECTLY BILLABLE TO CLIENTS**

Total employees' salary (from above)	$39,600
Salary allocated to overhead (from above)	8,120
Salary directly billable to clients	$31,480

3. **SCHEDULE COMPUTING TOTAL COST OF OPERATING THE FIRM PER CHARGEABLE MAN-HOUR OF EACH PROFESSIONAL EMPLOYEE**

(Overhead Allocated on the Basis of Each Employee's Billable Salary)

Employee	*Annual Salary*	*Annual Hours*	*Hourly Rate*	*Overhead Factor*	*Overhead Per Hour*	*Total Cost Per Hour*
Able	$ 2,400	1,200	$ 2.00	1.5	$ 3.00	$ 5.00
Briscol	12,000	2,400	5.00	1.5	7.50	12.50
Case	8,000	2,000	4.00	1.5	6.00	10.00
Dider	10,000	800	12.50	1.5	18.75	31.25
Emel	7,200	2,400	3.00	1.5	4.50	7.50

Computation of Overhead Application Factor

$$\frac{\text{Total overhead cost}}{\text{Salary billable to clients}} = \frac{\$47,220}{\$31,480} = 1.5$$

Proof of Overhead Allocation (not required)

Employee	*Total Cost Per Hour*	*Chargeable Hours*	*Total Per Employee*
Able	$ 5.00	720	$ 3,600
Briscol	12.50	2,160	27,000
Case	10.00	1,600	16,000
Dider	31.25	480	15,000
Emel	7.50	2,280	17,100
Total			$78,700
		Total employees' salary	$39,600
		Other overhead cost	39,100
		Total	$78,700

b. The effects are:

1. Under-absorption. Less billable salary will result in a smaller overhead allocation.
2. Under-absorption. Less billable salary will result in a smaller overhead allocation, but this will be offset by the 10 per cent reduced portion of Briscol's salary charged to overhead.
3. Over-absorption. More billable salary will result in a larger overhead allocation.
4. Over-absorption. Although the portion of Dider's salary allocated to overhead does not change, the increased billings to clients would cause more overhead to be allocated.
5. No change. Overhead is allocated as a part of the billing rate, not on salary.

Solution 5

a.

Delaney, Inc.

SCHEDULE TO COMPUTE FINISHED GOODS INVENTORY AT ACTUAL COST

June 30, 1969

	Inventory			
	Blacktown	*Orange*	*Indigo*	*Total*
Cost to manufacture	$ 78	$ 80	$ 80	
Freight	3	2	7	
Total unit cost	$ 81	$ 82	$ 87	
Units in inventory	3,000	1,000	2,000	
Total cost of inventory	$243,000	$82,000	$174,000	$499,000

b.

Delaney, Inc.

SCHEDULE TO ALLOCATE PRODUCTION TO MINIMIZE TOTAL FREIGHT COST

June 30, 1969

To Warehouses in	*From Factories in* Red City	Bluefield	Green Valley
Blacktown	5,000	1,000	6,000
Orange		16,000	
Indigo			9,000
Total shipments	5,000	17,000	15,000

c.

Delaney, Inc.

SCHEDULE TO COMPUTE FINISHED GOODS INVENTORY USING MINIMUM FREIGHT COST

June 30, 1969

	Inventory at Blacktown	Orange	Indigo	*Total*
Cost to manufacture	$ 78	$ 80	$ 80	
Freight	3	4*	3	
Total unit cost	$ 81	$ 84	$ 83	
Units in inventory	3,000	1,000	2,000	
Total cost of inventory	$243,000	$84,000	$166,000	$493,000

*All units would have been shipped from Bluefield.

d. The 1,000 units should be valued at $84,000 ($80,000 cost to manufacture plus $4,000 shipping cost from Bluefield to Orange, the cost and route if the misallocation had not been made). The $8,000 freight from Bluefield to Blacktown is a loss and should not be carried as an inventory cost which will be charged against future operations. A strong case could be made for valuing the units at $87,000 ($80,000 cost to manufacture plus $7,000 shipping cost from Blacktown to Orange) because this represents the final shipping cost to management's desired inventory location.

Solution 6

City of Homer

WORKSHEET TO ESTABLISH FUND BALANCES FOR FUNDS AND GROUPS OF ACCOUNTS

June 30, 1969

Debits	*Balance per Books*	*Adjustments Debit*	*Adjustments Credit*	*General Fund*	*Special Assessments Fund*	*General Fixed Assets*
Cash	$ 125,180			$ 125,180		
Cash for construction	174,000		(9)$ 24,000		$150,000	
Taxes receivable—current	8,000		(2) 8,000			
Assessments receivable—deferred	300,000				300,000	
Inventory of materials and supplies	38,000		(1) 250	37,750		
Improvements authorized	15,000		(8) 15,000			
Estimated revenues	4,135,000			4,135,000		
Interest expense	18,000				18,000	
Encumbrances	360,000		(10) 200,000		160,000	
Appropriation expenditures	4,310,000	(1)$ 250	(4) 32,000	4,078,250	205,000	
		(8) 5,000				
Taxes receivable—delinquent		(2) 8,000		8,000		
Due from State Revenue Department		(5) 75,000		75,000		
Equipment		(6) 90,000				$ 90,000
Land		(7) 250,000				250,000
Due from General Fund		(8) 10,000			10,000	
Cash for interest payments		(9) 24,000			24,000	
Construction work in progress		(11) 205,000				205,000
Total debits	$9,483,180			$8,459,180	$867,000	$545,000

Credits	*Balance per Books*	*Adjustments Debit*	*Adjustments Credit*	*General Fund*	*Special Assessments Fund*	*General Fixed Assets*
Allowance for uncollectible current taxes	$ 7,000	(3) 7,000				
Vouchers payable	62,090			$ 62,090		
Interest payable	18,000				$ 18,000	
Liability under street improvement project	10,000			10,000		
Bonds payable	300,000				300,000	
Premium on bonds	3,000				3,000	
Reserve for inventory	36,000		(1) 1,750	37,750		
Reserve for encumbrances	360,000	(10) 200,000			160,000	
Appropriations	4,450,000			4,085,000	365,000	
Unappropriated surplus	106,090	(1) 1,750		104,340		
Interest revenue	21,000				21,000	
Revenues	4,110,000	(4) 32,000	(3) 1,500	4,154,500		
			(5) 75,000			
Allowance for uncollectible delinquent taxes			(3) 5,500	5,500		
Investment in fixed assets from current revenues			(6) 90,000			$ 90,000
Investment in fixed assets from gifts			(7) 250,000			250,000
Investment in fixed assets from special assessments			(11) 205,000			205,000
Total credits	$9,483,180			$8,459,180	$867,000	$545,000
Adjustment totals		$908,000	$908,000			

Solution 6

City of Homer

ADJUSTING ENTRIES
(Not required)

(1)		
Appropriation expenditures	$ 250	
Unappropriated surplus	1,750	
Inventory of materials and supplies		$ 250
Reserve for inventory		1,750
To record inventory shortage of $250 and set aside surplus by amount of increase in inventory.		
(2)		
Taxes receivable—delinquent	8,000	
Taxes receivable—current		8,000
To reclassify current taxes now considered delinquent.		
(3)		
Allowance for uncollectible current taxes	7,000	
Allowance for uncollectible delinquent taxes		5,500
Revenues		1,500
To reclassify allowance for uncollectible current taxes now considered delinquent and adjust the balance to revised estimate.		
(4)		
Revenues	32,000	
Appropriation expenditures		32,000
To properly record discounts taken.		
(5)		
Due from State Revenue Department	75,000	
Revenues		75,000
To record amount due from State Revenue Department for state-collected, locally-shared tax.		
(6)		
Equipment	90,000	
Investment in fixed assets from current revenues		90,000
To record purchase of equipment for Police Department in general fixed assets group.		
(7)		
Land	250,000	
Investment in fixed assets from gifts		250,000
To record land donated to city in general fixed assets group.		
(8)		
Appropriation expenditures	5,000	
Due from General Fund	10,000	
Improvements authorized		15,000
To record city's share of street improvement project in special assessments fund.		

	(9)		
Cash for interest payments		$ 24,000	
Cash for construction			$ 24,000
To reclassify bond premium and interest collected on assessments.			
	(10)		
Reserve for encumbrances		200,000	
Encumbrances			200,000
To cancel encumbrances for contractor's progress billings.			
	(11)		
Construction work in progress		205,000	
Investment in fixed assets from special assessments			205,000
To record street improvement expenditures in general fixed assets group.			

ACCOUNTING PRACTICE—PART II

November 6, 1969; 1:30 to 6:00 p.m.

Solution 1

a.

Art Company

SCHEDULE COMPUTING COST OF INVENTORY USING THE WEIGHTED AVERAGE METHOD

December 31, 1968

	Units	*Cost*
Inventory, December 31, 1967	800,000	$ 240,000
Purchases:		
January	600,000	210,000
April	500,000	200,000
September	1,000,000	246,000
November	400,000	160,000
Goods available for sale	3,300,000	$1,056,000
Average Unit Cost ($1,056,000 ÷ 3,300,000)		$.32
Inventory, December 31, 1968 (1,000,000 × $.32)		$320,000

b. **Bat Company**

SCHEDULE COMPUTING COST OF UNSOLD LOTS

December 31, 1968

Cost of Land Acquired

Cost of land	$100,000
Add cost to level	25,000
Total cost of land acquired	$125,000

Apportionment of Total Cost to Lots in Ratio of Selling Price

Class	Sales Price Per Lot	No. of Lots	Total	Per Cent of Total	Apportioned Cost Total	Apportioned Cost Per Lot
A	$4,000	25	$100,000	50%	$ 62,500	$2,500
B	3,000	30	90,000	45	56,250	1,875
C	1,000	10	10,000	5	6,250	625
			$200,000	100%	$125,000	

Cost of Unsold Lots at December 31, 1968

Class	No. of Lots Unsold 12/31/68	Cost Per Lot	Cost of Unsold Lots 12/31/68
A	15	$2,500	$37,500
B	6	1,875	11,250
C	3	625	1,875
	Cost of unsold lots at December 31, 1968		$50,625

c. **Cot Company**

SCHEDULE OF ADJUSTMENTS TO INVENTORY TO EFFECT A PROPER CUTOFF

December 31, 1968

Inventory as reported December 31, 1968	$19,600
Adjustments to effect a proper cutoff:	
(1) Beds received not recorded until January	9,000
(2) Beds recorded twice	(1,900)
(3) Beds shipped	(7,000)
(4) Unrecorded receipt	2,300
Adjusted inventory December 31, 1968	$22,000

d.

Dale Company

**SCHEDULE OF INCOME FOR 1966, 1967 AND 1968
COMPUTED USING THE PERCENTAGE-OF-COMPLETION METHOD
BASED ON COSTS INCURRED**

Explanation	*1966*		*1967*		*1968*	
Contract price		$700,000		$700,000		$700,000
Less:						
Accumulated contract costs	$ 49,600		$172,800		$378,000	
Estimated cost to complete contract	570,400	620,000	467,200	640,000	252,000	630,000
Income from contract (estimated)		80,000		60,000		70,000
Per cent complete (accumulated costs ÷ total estimated costs):						
1966—$ 49,600 ÷ $620,000		8%				
1967—$172,800 ÷ $640,000				27%		
1968—$378,000 ÷ $630,000						60%
Income from contract, earned to date		6,400		16,200		42,000
Income assigned to prior years				6,400		16,200
Income from contract		$ 6,400		$ 9,800		$ 25,800

Solution 2

a.

Ross Shirts, Inc.

STANDARD COST OF PRODUCTION

For the Month Ending October 31, 1969

Lot	*Quantity*	*Standard Cost Per Unit*	*Total Standard Cost*
30	1,000	$26.55	$ 26,550
31	1,700	26.55	45,135
32	1,200	23.88*	28,656
		Standard Cost of Production	$100,341

*Standard material cost plus 80% of standard cost of labor and overhead [$13.20 + (.80 × $13.35)].

b.

Ross Shirts, Inc.

SCHEDULE COMPUTING MATERIALS PRICE VARIANCE

For the Month Ending October 31, 1969

Actual cost of materials purchased	$53,200
Standard cost of materials purchased (95,000 × $.55)	52,250
Unfavorable materials price variance	$ 950

c. **Ross Shirts, Inc.**

SCHEDULE OF MATERIAL AND LABOR VARIANCES

For the Month Ending October 31, 1969

	Total	Lot No. 30	Lot No. 31	Lot No. 32
Materials quantity variance:				
Standard yards:				
Units in lot	3,900	1,000	1,700	1,200
Standard yards per lot	24	24	24	24
Total standard quantity	93,600	24,000	40,800	28,800
Actual yards used	93,365	24,100	40,440	28,825
Variance in yards	(235)	100	(360)	25

	Total	Lot No. 30	Lot No. 31	Lot No. 32
Labor efficiency variance:				
Standard hours:				
Units in lot	3,900	1,000	1,700	1,200
Standard hours	3	3	3	3
Total	11,700	3,000	5,100	3,600
Percentage of completion		100	100	80
Total standard hours	10,980	3,000	5,100	2,880
Actual hours worked	11,000	2,980	5,130	2,890
Variance in hours	20	(20)	30	10

	Total	Lot No. 30	Lot No. 31	Lot No. 32
Labor rate variance:				
Actual hours worked	11,000	2,980	5,130	2,890
Rate paid in excess of standard ($2.50-$2.45)	$ .05	$ .05	$ .05	$ .05
Variance	$550.00	$149.00	$256.50	$144.50

( ) indicates favorable variance

d. **Ross Shirts, Inc.**

SCHEDULE OF OVERHEAD VARIANCES

For the Month Ending October 31, 1969

Controllable variance:		
Actual overhead		$22,800
Budgeted overhead for level of production attained:		
Fixed overhead (.40 × $288,000/12)	$ 9,600	
Variable overhead ($2 × .60 × 10,980 standard hours)	13,176	
Total budgeted overhead		22,776
Unfavorable controllable variance		$ 24
Noncontrollable variance:		
Budgeted overhead for level of production attained		$22,776
Overhead applied to production (10,980 standard hours × $2)		21,960
Unfavorable noncontrollable variance		$ 816

Solution 3

a. 1.

Relgne Corporation

SCHEDULE COMPUTING COLLECTIONS OF ACCOUNTS RECEIVABLE

For the Year Ending October 31, 1969

Beginning accounts receivable			$100,000
Add increase from sales:			
Sales revenue earned		$898,000	
Beginning unearned revenue	$9,000		
Ending unearned revenue	1,000	8,000	
Increase in A/R from sales			890,000
Total accounts to be collected			990,000
Deduct accounts not collected:			
Beginning allowance		$ 5,000	
Bad debts added		4,000	
Total		9,000	
Ending allowance		8,000	
Accounts charged-off		1,000	
Ending accounts receivable		148,000	
Total accounts not collected			149,000
Total accounts collected			$841,000

2.

Relgne Corporation

SCHEDULE COMPUTING PAYMENTS OF ACCOUNTS PAYABLE

For the Year Ending October 31, 1969

Beginning accounts payable		$ 60,000
Add purchases:		
Ending inventory	$291,000	
Cost of goods sold	539,000	
Merchandise available for sale	830,000	
Beginning inventory	300,000	
Merchandise purchased		530,000
Total due during year		590,000
Deduct ending accounts payable		55,000
Total payments of accounts payable		$535,000

b.

Relgne Corporation

STATEMENT OF SOURCES AND USES OF CASH

For the Year Ending October 31, 1969

Cash receipts:		
Operations:		
Collections from customers		$841,000
Less: Payment of accounts payable	$535,000	
Payment of operating expenses	254,500	
Purchase of insurance	2,500	
Payment of income tax	10,000	802,000
Increase in cash resulting from operations		39,000
Sale of long-term investments		42,000
Sale of equipment		7,000
Sale of treasury stock		6,000
Sale of common stock		210,000
Total cash receipts		304,000
Cash payments:		
Deposit to sinking fund	$ 10,000	
Purchase of equipment	90,000	
Payment of current portion of long-term note payable	20,000	
Payment of dividends	8,000	128,000
Increase in cash		$176,000

Supporting Computations:

1. Cash received from sale of long-term securities:		
Decrease in cost	$ 30,000	
Gain on sale	12,000	
Total cash received	$ 42,000	
2. Cash received from sale of treasury stock:		
Decrease in cost	$ 5,000	
Gain on sale	1,000	
Total cash received	$ 6,000	
3. Cash received from sale of common stock:		
Increase in common stock		$100,000
Increase in paid-in capital	$111,000	
Less increase from treasury stock	1,000	110,000
Total cash received		$210,000
4. Cash paid to purchase equipment:		
Increase in equipment	$125,000	
Add equipment sold	15,000	
Total equipment purchased	140,000	
Deduct note payable	50,000	
Total cash paid	$ 90,000	

5. Cash paid for operating expenses:

Selling and general expenses		$287,000
Deduct expenses not paid by cash:		
Amortization of bond discount	$ 500	
Increase in accrued expenses payable	3,000	
Expired insurance	2,000	
Building depreciation	3,750	
Equipment depreciation	19,250	
Bad debts expense	4,000	
Total expenses not paid by cash		32,500
Total expense paid by cash		$254,500

6. Cash paid out as dividends:

Beginning retained earnings	$112,000
Deduct appropriation for sinking fund	10,000
Balance	102,000
Ending retained earnings	94,000
Total dividends paid by cash	$ 8,000

Solution 4

a. COMPUTATION OF TOTAL NET DEFERRED TAX CREDITS (DEBITS)

	1965	*1966*	*1967*
Timing differences taxed at ordinary rates:			
Net deductions for income tax purposes	$70,000	$ (4,000)	$46,800
Net deductions for financial statement purposes as adjusted	42,000	22,000	31,500
Tax deductions in excess of financial statement deductions	28,000	(26,000)	15,300
Tax rate on ordinary income	48%	48%	48%
Deferred tax credits (debits) at ordinary rates	13,440	(12,480)	7,344
Deferred tax credit at 25% capital gains rate			11,250
Total net deferred tax credits (debits)	13,440	$(12,480)	18,594
Cumulative total deferred tax credits	$13,440	$ 960	$19,554

Computation of Net Deductions for Tax Reporting Purposes Giving Rise to Interperiod Tax Allocation Taxed At Ordinary Income Tax Rates

Depreciation—packaging equipment			
($225,000 — $15,000) × 5/15	$70,000		
($225,000 — $15,000) × 4/15		$ 56,000	
($225,000 — $15,000) × 3/15			$42,000
Depreciation—office equipment			2,800
Patent amortization ($34,000 ÷ 17)			2,000
Total deductions	70,000	56,000	46,800
Less rental income		60,000	
Net deductions for income tax reporting	$70,000	$ (4,000)	$46,800

Note: Investment credit is ignored in computing interperiod tax allocation.

Computation of Net Deductions for Financial Statements as Adjusted Giving Rise to Interperiod Tax Allocation Taxed At Ordinary Income Tax Rates

	1965	*1966*	*1967*
Depreciation—packaging equipment:			
As shown on financial statements ($225,000 — $15,000 — $5,250) ÷ 5	$40,950	$40,950	$40,950
Add back proration of investment credit ($5,250 ÷ 5)	1,050	1,050	1,050
Depreciation based on cost less salvage value ($225,000 — $15,000) ÷ 5	42,000	42,000	42,000
Depreciation—office equipment ($10,000 ÷ 10)			1,000
Patent amortization ($34,000 ÷ 4)			8,500
Total deductions	42,000	42,000	51,500
Less rental income ($60,000 ÷ 3)		20,000	20,000
Net deductions for financial statements as adjusted	$42,000	$22,000	$31,500

Computation of Deferred Tax Credit At Capital Gains Rate—1967

Gain on sale of land for financial reporting purposes ($200,000 — $150,000)	$50,000
Gain on sale of land for tax reporting purposes ($200,000 — $150,000) ÷ 10	5,000
Deferred gain for tax reporting purposes	$45,000
Capital gains rate	25%
Deferred tax credit at capital gains rate	$11,250

b. **COMPUTATION OF TOTAL INCOME TAX EXPENSE FOR FINANCIAL REPORTING PURPOSES**

	1965	*1966*	*1967*
Income taxes per tax returns	$33,850	$77,020	$51,966
Add investment credit	5,250		
Income taxes before investment credit	39,100	77,020	51,966
Add deferred tax credits (debit)	13,440	(12,480)	18,594
Total income tax expense	$52,540	$64,540	$70,560

Solution 5

Estate of Jac Allen and Owned Companies
CONSOLIDATED WORKSHEET
September 30, 1969

Debits	Allen Estate	Bass Corporation	Crane Investments, Inc.	Adjustments Debit	Adjustments Credit	Eliminations Debit	Eliminations Credit	Consolidated Balance Sheet
Cash in bank	$ 45,000	$ 195,000	$ 45,000					$ 285,000
Due from Crane Investments, Inc.		4,500					$ 4,500(7)	
Investments at cost:								
Corporate bonds	300,000	500,000						800,000
Marketable securities								
Purchased prior to June 30, 1963		794,000		$ 6,000(4)				800,000
Purchased after June 30, 1963		2,000,000	439,000					2,439,000
Stock of Bass Corporation—90% interest at cost	2,250,000			450,000(6)			2,700,000(10)	
Stock of Crane Investments, Inc.—80% interest at cost		156,000		28,000(5)			184,000(8)	
Accrued interest receivable		21,000		9,000(2)				30,000
Trustees' expenses, taxes, etc. paid	218,000				$ 218,000(3)			
Distributions to sister	296,000			4,000(1)	300,000(3)			
	$3,109,000	$3,670,500	$484,000					$4,354,000

Credits	Allen Estate	Bass Corporation	Crane Investments, Inc.	Adjustments Debit	Adjustments Credit	Eliminations Debit	Eliminations Credit	Consolidated Balance Sheet
Sundry liabilities		$ 373,500	$ 38,250		4,000(1)			$ 415,750
Due to Bass Corporation			4,500			$ 4,500(7)		
Income from dividends	$ 460,000			460,000(3)				
Interest income	72,000			81,000(3)	9,000(2)			
Gain on sale of bonds	2,000			2,000(3)				
Equity of Jac Allen:								
Estate corpus	2,575,000				2,000(3) 450,000(6)		450,000(10)	3,477,000
Estate income					23,000(3)			23,000
Capital stock:								
Bass Corporation:								
Allen estate—90%		2,250,000				2,250,000(10)		
Minority interest		250,000						250,000M
Crane Investment, Inc.:								
Bass Corporation—80%			160,000			160,000(8)		
Minority interest			40,000					40,000M
Retained earnings:								
Bass Corporation:								
Allen estate—90%		717,300			5,400(4) 25,200(5)	21,600(8) 900,000(10)	173,700(9)	
Minority interest		79,700			600(4) 2,800(5)	2,400(8)	19,300(9)	100,000M
Crane Investments, Inc.:								
Bass Corporation—80%			193,000			193,000(9)		
Minority interest			48,250					48,250M
	$3,109,000	$3,670,500	$484,000	$1,040,000	$1,040,000	$3,531,500	$3,531,500	$4,354,000

Estate of Jac Allen and Owned Companies

ADJUSTING JOURNAL ENTRIES
(Not Required)

(1)

Distributions to sister	$ 4,000	
Sundry liabilities		$ 4,000
To record monthly allowance due sister		

(2)

Accrued interest receivable	9,000	
Interest income		9,000
To record interest on estate bonds		

(3)

Income from dividends	460,000	
Interest income	81,000	
Gain on sale of bonds	2,000	
Trustees' expenses, taxes, etc. paid		218,000
Distributions to sister		300,000
Estate corpus		2,000
Estate income		23,000
To close nominal accounts		

(4)

Marketable securities—Bass Corporation	6,000	
Retained earnings—Bass Corporation (Allen estate 90% interest)		5,400
Retained earnings—Bass Corporation (Minority interest)		600
To increase the book value of marketable securities still on hand to market value at date of death ($800,000 — $794,000)		

(5)

Stock of Crane Investment, Inc.	28,000	
Retained earnings—Bass Corporation—(Allen estate 90% interest)		25,200
Retained earnings—Bass Corporation—(Minority interest)		2,800
To record excess of market value of Crane Investments, Inc. stock at date of death over cost.		

Net worth per Crane books, June 30, 1963:		
Capital stock	$200,000	
Retained earnings	20,000	$220,000
Add: Increase in value of marketable securities over cost, June 30, 1963:		
Market value	250,000	
Cost	240,000	10,000
Net worth on June 30, 1963		$230,000
Equity of Bass Corporation in Crane Investments, Inc. at June 30, 1963 ($230,000 × 80%)		$184,000
Less cost of investment in Crane Investments, Inc.		156,000
Excess of market value of investment in Crane Investments, Inc. at date of death over cost		$ 28,000

(6)

Stock of Bass Corporation	$450,000	
Estate corpus		$450,000
To record excess of value of investment in Bass Corporation at date of death over cost		

ELIMINATING ENTRIES
(Not Required)

(7)

Due to Bass Corporation	$ 4,500	
Due from Crane Investments, Inc.		$ 4,500
To eliminate inter-company accounts		

(8)

Capital stock—Crane Investments, Inc.—(Bass Corporation interest)	160,000	
Retained earnings—Bass Corporation—(Allen estate 90% interest)	21,600	
Retained earnings—Bass Corporation—(Minority interest)	2,400	
Stock of Crane Investments, Inc. (80% × $230,000)		184,000
To eliminate 80% majority interest at date of death		

(9)

Retained earnings—Crane Investments, Inc.— (Bass Corporation interest)	$193,000	
Retained earnings—Bass Corporation— (Allen estate 90% interest)		$173,700
Retained earnings—Bass Corporation— (Minority interest)		19,300

To segregate an 80% majority interest in Crane Investments, Inc. retained earnings belonging to Bass Corporation

(10)

Capital stock—Bass Corporation— (Allen estate 90% interest)	2,250,000	
Retained earnings—Bass Corporation— (Allen estate 90% interest)	900,000	
Stock of Bass Corporation		2,700,000
Estate corpus		450,000

To eliminate 90% Allen estate interest in Bass Corporation at date of death

AUDITING

November 6, 1969; 8:30 a.m. to 12:00 m.

Answer 1

1. c	9. b
2. d	10. c
3. d	11. a
4. a	12. b
5. c	13. a
6. a	14. c
7. b	15. d
8. b	16. d

Answer 2

a. 1. An audit confirmation is a written statement to the CPA from someone outside the enterprise on a fact which that person is qualified to affirm.

2. The two main characteristics a confirmation should possess are:

(a) The party supplying the information requested must be knowledgeable and independent, i.e., he must have knowledge of information of interest to the auditor and he must be outside the scope of influence of the organization being audited; and

(b) the auditor must obtain the information directly from the informed party.

b. 1. A written representation, usually in the form of a letter to the CPA, is a statement by responsible officials of the audit client that the financial statements present fairly the financial position and results of operations to the best of the officials' knowledge.

2. Information which should be contained in a representation varies, but typically includes the following:
   (a) The client has title to all assets, and all related encumbrances are recorded.
   (b) Receivables, inventories, and fixed assets are properly classified and recorded and quantities and cost (or market, if lower) agree with the amounts recorded.
   (c) All ascertainable liabilities of material amount are recorded.
   (d) Adequate provisions for all material contingent liabilities are recorded or each contingent liability is stated in the representation.
   (e) All minutes of directors' and stockholders' meetings are correct and complete and have been made available to the auditors.
   (f) No events subsequent to the period of the statements up to the date of the representation would have a material effect on those statements.

3. A representation has no effect on a CPA's examination of a client's financial statements, except to the extent that it reveals information which might not otherwise be obtained (such as an unrecorded contingent liability not disclosed in the client's records and unknown by the client's attorney). The representation is a complement to, rather than a substitute for, a proper examination and is solicited by the CPA to secure the full and active co-operation of the client in the examination.

c. 1. In a positive confirmation the customer is asked to reply, stating whether the amount shown is correct or incorrect. In a negative confirmation the customer is asked to respond only if the amount shown is incorrect.

2. The characteristics which should be present in the accounts if the CPA is to use negative confirmations are:
   (a) The composition of the accounts to be confirmed, i.e., many accounts with small (insignificant) balances.
   (b) The appearance of good internal control.
   (c) The absence of large balances in the accounts, especially of a material amount.
   (d) No indications of any disputes or irregularities in the accounts.

d. The following information should be requested in a bank confirmation:

1. The cash balance(s) of all accounts which the client has with the bank.
2. Whether the account is subject to withdrawal by check and whether the account bears interest.
3. Whether the client has any direct liability on loans, acceptance or other such documents.
4. Whether the client has any contingent liability for discounted notes or as guarantor for others.
5. Whether the client has any other direct or contingent liability, any open letters of credit, or any collateral held by the bank.

6. Whether the client has any security agreements under the Uniform Commercial Code.

Answer 3

a. The audit objectives in the examination of long-term debt are to determine that:
1. All liabilities were properly recorded.
2. Items recorded as liabilities are bona fide obligations.
3. Interest expense and/or amortization was properly computed and recorded.
4. The client is not in violation of restrictions or requirements imposed on it by the terms of the loan agreements.
5. Satisfactory authority existed to enter into long-term obligation agreements.
6. All long-term obligations are properly classified in the balance sheet.
7. Assets pledged as security are adequately disclosed.

b. The following procedures should be included in an audit program for the examination of the long-term note agreement between Ronlyn and Second National Bank:
1. Confirm the loan and terms of the agreement with the bank.
2. Review the agreement between Ronlyn and the bank to determine that:
   (a) The debt is long-term (by reference to dates).
   (b) Provisions of the agreement have not been violated, e.g., that Ronlyn is complying with any restrictions on the payment of dividends, on the amount of working capital to be maintained, or on the uses to which the funds may be employed and is maintaining the plant pledged as security for the loan.
   (c) The agreement was signed by person(s) having authority.
3. Trace the receipt of funds into the bank account and cash receipts book.
4. Check the computation of interest expense for the period May 1 to June 30, 1969 and trace the recording of the expense and the accrual on the books.
5. Determine that authority to borrow was granted and is recorded in the board of director's minutes.

c. The security position of Ronlyn could be verified by counting and inspecting the securities at audit date. As part of the inspection you would note the following for comparison with the books: serial numbers, name of issuer, face value, par value and quantities represented by each certificate, name in which registered—(should be Ronlyn Corporation), interest dates and dividend rates, if any. If the securities were in the hands of a custodian and not available for inspection at audit date, a confirmation from the custodian which identified the securities and ownership thereof at June 30, 1969 would be satisfactory.

d. 1. The dividend and interest income should be verified by comparing the income as recorded to an independent source, i.e., a newspaper, dividend record, etc. Bond interest income may be verified by computation.

2. Market value can be checked by reference to independent sources, such as newspapers. In cases where there is no ready market, estimates may be based on the best information available. (A recent sale would be regarded as best.)
3. Authority for security purchases could be established by reading:
   (a) The document containing the authorization, such as company's minutes, and
   (b) The loan agreement with the bank. Permission from the bank may be required to invest loan proceeds in securities.

Answer 4

a. 1. An audit program for observation of inventory of Household Appliances' retail outlet would include the following procedures:
   1. Read client's inventory plan and instructions, discuss them with client, and recommend revisions as necessary.
   2. Evaluate the system of internal control as it pertains to the recording of and physical control over inventory transactions. Revise audit scope as appropriate based on this review and tests of the system.
   3. Observe client's inventory procedures and physical count of the merchandise for compliance with plan and instructions.
   4. Make test counts of the merchandise for comparison with client's count and trace correct count into inventory compilation noting tag number, merchandise code, descriptions, price, unit, and quantity. All inventory items should be tagged, and an accounting should be made of all tags.
   5. Trace a sample of client's count sheets or tags into inventory compilation, noting items as in 4 above.
   6. Verify accuracy of inventory cut-off.
   7. Observe physical conditions of the inventory and follow up to see that client has provided for damage, deterioration, and obsolescence.

2. An audit program for observation of the physical inventory at the warehouse would be generally the same as that given above for the inventory held at the retail store with the following additional procedures:
   1. Determine the adequacy of the safeguards against unauthorized removal of inventory.
   2. Determine the adequacy of segregation of the client's merchandise from the merchandise of others.
   3. Compare the test counts with the warehouseman's report submitted to the client.
   4. Observe the inventories at the warehouse and retail outlet simultaneously.

b. 1. Yes. It is standard auditing procedure to confirm inventories held in a public warehouse. Particularly would this procedure be necessary if observation of a physical inventory of this merchandise were omitted as not practicable.

When the taking of the client's warehouse inventory is observed by the CPA, confirmation from the warehouseman is still a desirable audit procedure inasmuch as this would provide additional evidence. The inventory observation affirms the existence of the asset; the confirmation attests to both the existence and the ownership of the asset. Evidence from an external independent source (the confirmation) is of a higher quality than evidence internally generated or received by the auditor from the client (the record of the physical inventory or the monthly report to the client).

The warehouseman's independence as a public contractor is not affected by his issuance of inventory on written or telephoned orders from the client or his issuance of a monthly report used as basis for book adjustments by the client. These procedures are common where goods are stored on the basis of nonnegotiable warehouse receipts issued to the owner. If adjustments to the book inventory are frequent or material and internal control is weak, the CPA must not ignore the possibility of collusion between his client and the warehouseman or one of his employees. In such a case the warehouseman's confirmation would be of doubtful value.

2. Yes. Observation of a physical inventory, including test counts, by a CPA is a standard audit requirement where the procedure is practicable and reasonable and the inventory is material to financial position or results of operations. When inventories are held in a public warehouse, test counts should be made in addition to obtaining confirmation from the warehouseman. It is always possible that what appears to be a bona fide confirmation was sent from a ghost warehouse to confirm a nonexistent inventory.

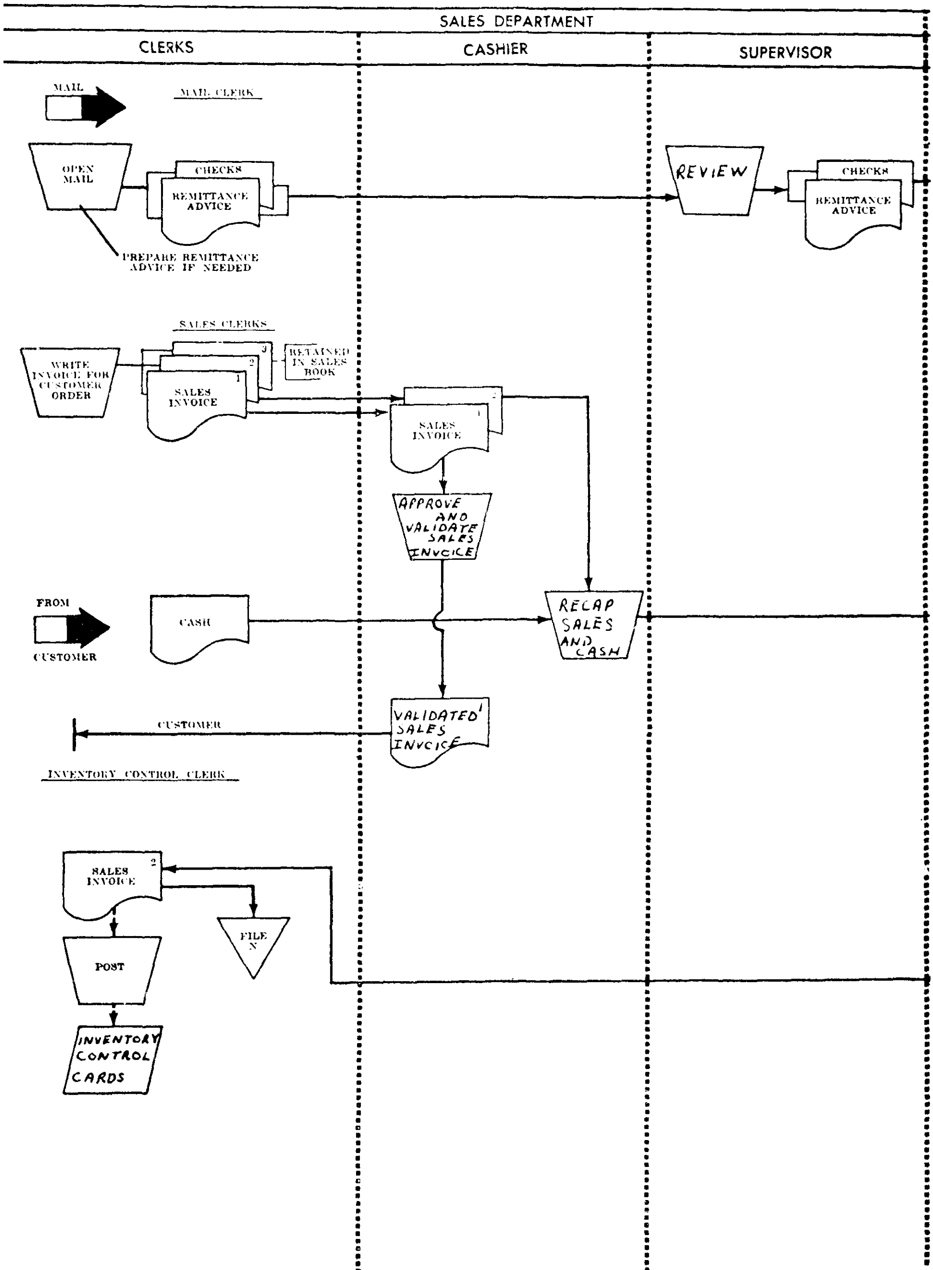
   The CPA has further reason for test-counting Household's year-end inventory at the warehouse because no physical counts of the merchandise at the warehouse had been made by the client during the year, and because of possible poor internal control.

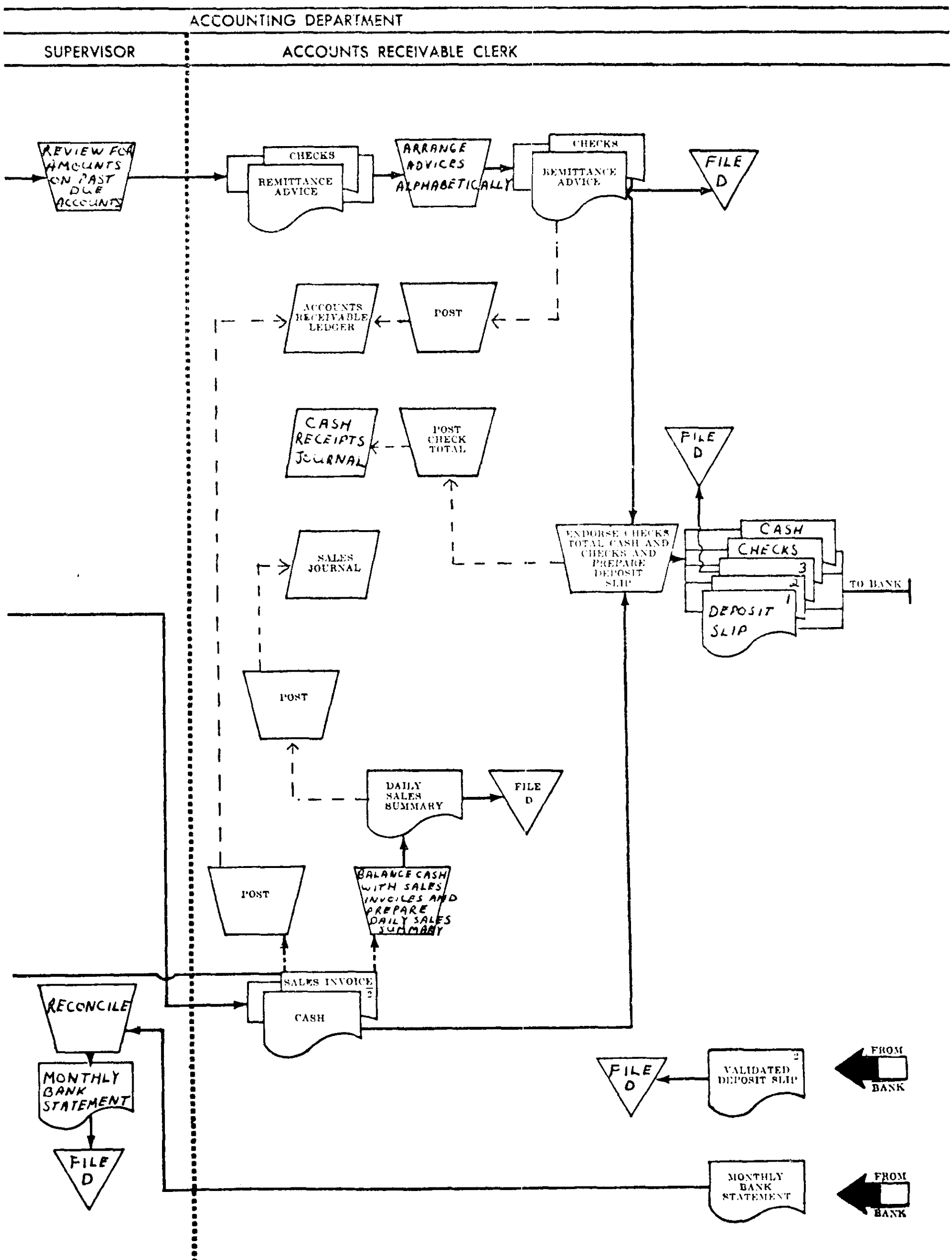
c. Substantial year-end adjustments of the book inventory to bring it into agreement with the physical inventory of the merchandise at the warehouse suggest various conditions:
1. Break-down of internal control over inventory transactions so that the monthly adjustments by the bookkeeper are based on an inaccurate warehouse report.
2. Lack of synchronization in cut-off of inventory transactions as between the bookkeeper's inventory record and the warehouse inventory record.
3. Errors in recording inventory transactions.
4. Errors in the preparation of the monthly or year-end warehouse reports.
5. Inaccurate adjustments of book inventory to warehouse monthly reports.

d. No. The nature of the business suggests that inventories are a major income producing factor as well as a significant asset on the balance sheet. If procedures disclose material misstatement of the inventory, a qualified or adverse opinion, based on the degree of materiality, is required. If the auditor is unable to carry out necessary procedures, a disclaimer of opinion may be required.

Answer 5

Charting Inc.
FLOW CHART FOR SALES AND CASH RECEIPTS




ACCOUNTING DEPARTMENT
SUPERVISOR
ACCOUNTS RECEIVABLE CLERK
REVIEW FOR AMOUNTS ON PAST DUE ACCOUNTS
CHECKS
REMITTANCE ADVICE
ARRANGE ADVICES ALPHABETICALLY
CHECKS
REMITTANCE ADVICE
FILE D
ACCOUNTS RECEIVABLE LEDGER
POST
CASH RECEIPTS JOURNAL
POST CHECK TOTAL
FILE D
ENDORSE CHECKS TOTAL CASH AND CHECKS AND PREPARE DEPOSIT SLIP
CASH
CHECKS
3
2
1
DEPOSIT SLIP
TO BANK
SALES JOURNAL
POST
DAILY SALES SUMMARY
FILE D
POST
BALANCE CASH WITH SALES INVOICES AND PREPARE DAILY SALES SUMMARY
SALES INVOICE
2
CASH
RECONCILE
MONTHLY BANK STATEMENT
FILE D
FILE D
VALIDATED DEPOSIT SLIP
2
FROM BANK
MONTHLY BANK STATEMENT
FROM BANK

Answer 6

a. The independence and professional reputation of the foreign auditors could be evaluated and accepted by:

1. Assuring yourself that the other accountants are licensed, where required by statute, or hold other appropriate qualifications similar to those required for certification in the U.S.
2. Determining if they are members of professional bodies similar in nature and purpose to the AICPA which have corresponding rules of professional conduct.
3. Ascertaining that their work was performed and their reports issued in accordance with generally accepted auditing standards and that the financial statements were prepared in accordance with generally accepted accounting principles, as prevailing in the U.S., and that any differences were disclosed and discussed with the other accountants.
4. Reviewing the working papers of the other accountants and/or having personal consultations or correspondence with them if considered necessary.

b. The principal auditor may be willing to assume responsibility for the work of another auditor to the same extent as though he had performed the work himself when:

1. The principal auditor engaged the other auditor as his agent; or
2. The other independent auditor is an affiliated or correspondent firm whose work is usually accepted by the principal auditor; or
3. The principal auditor made sufficient review of the other auditor's work to justify accepting full responsibility; or
4. The amounts are immaterial.

c. 1. The disclosure in the scope paragraph of the auditor's report should read as follows:

> *We did not examine the financial statements of the consolidated foreign subsidiaries which were examined by other independent auditors whose reports were furnished to us. Our opinion expressed herein, insofar as it relates to the amounts included for the consolidated subsidiaries, is based solely on the reports of these other auditors.*

2. The opinion paragraph of the auditor's report should read as follows:

> *In our opinion, the accompanying consolidated balance sheet and consolidated statements of income and retained earnings present fairly the consolidated financial position of Pace Corporation and its consolidated subsidiaries at June 30, 1969, and the consolidated results of their operations for the year then ended in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.*

(As an alternative, reference to the report of the other independent auditor as the basis, in part, for the opinion expressed may be placed in the opinion paragraph rather than in the last sentence of the scope paragraph.)

d. The unaudited amounts in the financial statements should be clearly marked as "unaudited" and the auditor should insert a disclaimer similar to the following in his auditor's opinion:

We did not examine the consolidated financial statements for the year ended June 30, 1968 and accordingly do not express an opinion on them.

Since the auditors did not observe the beginning inventory, unless they were able to satisfy themselves as to the beginning inventory by other auditing procedures, your opinion would have to be limited to the consolidated balance sheet at June 30, 1969, and, depending upon the materiality of the amount involved, a qualification or disclaimer of opinion would have to be issued on the consolidated statement of income and retained earnings for the year ended June 30, 1969. If satisfaction as to beginning inventory were obtained, your auditor's opinion could be unqualified and failure to observe beginning inventories need not be mentioned.

In addition, a limited examination of the financial statements of the prior year must be made, as the auditor must satisfy himself as to consistency in the application of generally accepted accounting principles.

Answer 7

a. Auditor's independence as it relates to third party reliance upon financial statements suggests that the auditor's professional judgment must be self-reliant and not subordinate to the views of his clients in fact or in appearance.

Investors, credit grantors, prospective purchasers of businesses, regulatory agencies of government, and others may rely on an auditor's opinion that financial statements fairly reflect the financial position and results of operations of the enterprise which he has audited. To be independent the auditor must not only consciously refuse to subordinate his judgment to that of others, but he must also avoid relationships which would appear likely to warp his judgment even subconsciously in reporting whether or not the financial statements he has audited are in his opinion fairly presented.

Independence means avoidance of situations which would tend to impair objectivity or create personal bias which would influence delicate judgments or lead a reasonable observer to believe that such objectivity might have been impaired In its essence, independence is an expression of the professional integrity of the auditor and is primarily a condition of mind, character and appearance.

b. 1. An auditor's independence "in fact" refers to his objectivity, to the quality of not being influenced by regard to personal advantage. The auditor is in fact independent if his judgments are uncolored by personal interests, the interest of his client or other special parties. Thus, independence in fact exists if the auditor exercises an objective state of mind.

2. The auditor is independent in appearance when no potential conflict of interest exists which might tend to jeopardize public confidence in the auditor's independence in fact. For there to be independence in appearance, there should be no reason to suspect that any factors exist which may influence the uninhibited exercise of the auditor's professional judgment.

c. An auditor may be independent in fact, i.e., have an objective state of mind, but appear to third parties not to be independent. This situation arises where potential conflicts of interest exist which might tend to jeopardize public confidence in the auditor's independence in fact.

For example, an auditor might not appear to be independent through the eyes of third parties, even though he might be independent in fact, if he or one of his partners (a) during the period of his professional engagement or at the time of expressing his opinion, had, or was committed to acquire, any direct financial interest or material indirect financial interest in the enterprise, (b) during the period of his professional engagement, at the time of expressing his opinion or during the period covered by the financial statements, was connected with the enterprise as a promoter, underwriter, voting trustee, director, officer or key employee or (c) renders professional services for a fee which would be contingent upon the findings or results of such services, except in certain tax matters when the contingent fee is determined by a court.

The auditor may not be independent in appearance if there exists the opportunity for personal advantage as a result of his opinions even though he in fact ignores such considerations in rendering his objective, unbiased professional judgment.

d. 1. No. A CPA would be considered not independent for an examination of the financial statements of a church for which he is serving as treasurer without compensation. The CPA's independence would be impaired in the eyes of someone who had knowledge of all the facts since the CPA would be reporting on his stewardship of the church's funds as its treasurer, even though without compensation.

2. No. A CPA would be considered not independent for an examination of the financial statements of a women's club for which his wife is serving as treasurer-bookkeeper even though he is not to receive a fee. The CPA's independence would be impaired in the eyes of someone who had knowledge of all the facts because the CPA might not be considered objective and unbiased in evaluating his wife's stewardship as treasurer and her record keeping as bookkeeper. The fact that the CPA would not receive a fee would usually not affect his independence.

e. A disclaimer of opinion such as should accompany financial statements examined by a CPA who owns a material direct financial interest in his audit client follows:

> *Inasmuch as we have a direct financial interest in Client Company and therefore are not considered independent, our examination of the accompanying financial statements was not conducted in accordance with generally accepted auditing standards. Accordingly, we are not in a position to and do not express an opinion on these financial statements.*

The auditor should not state that the financial statements were prepared in accordance with generally accepted accounting principles because such a statement would indicate that the auditor need not be independent to express an opinion on his client's adherence to generally accepted accounting principles.

COMMERCIAL LAW

November 7, 1969; 8:30 a.m. to 12:00 m.

Answer 1

1. False
2. False
3. True
4. False
5. False
6. False
7. True
8. False
9. False
10. True
11. False
12. True
13. True
14. False
15. False
16. True
17. True
18. True
19. False
20. False
21. True
22. False
23. False
24. True
25. False
26. True
27. False
28. True
29. True
30. False

Answer 2

31. True
32. False
33. True
34. True
35. False
36. False
37. False
38. True
39. False
40. True
41. True
42. False
43. True
44. False
45. True
46. False
47. True
48. True
49. True
50. True
51. True
52. True
53. True
54. False
55. False
56. False
57. True
58. True
59. True
60. False

Answer 3

61. True
62. False
63. True
64. False
65. False
66. True
67. True
68. False
69. False
70. False
71. False
72. True
73. True
74. True
75. False
76. True
77. False
78. True
79. False
80. True
81. True
82. False
83. False
84. False
85. True
86. True
87. False
88. True
89. False
90. False

Answer 4

a. 1. Yes. As a director Andrews owed a fiduciary duty to the Corporation, which required that he disclose to the Corporation the business opportunity of which he had learned to enable the Corporation to take advantage of the opportunity. His status as a director further prohibited his diversion of this opportunity to himself and the consequent profit he made at the expense of the Corporation. In such a situation, the Corporation could recover such profit from Andrews.

2. A director may deal with his Corporation if he does so at arm's-length after full disclosure and the transaction is approved by a majority of the other directors not interested therein. Thus, if Andrews had owned the mineral rights before becoming a director, had offered them to the Corporation in an arm's-length offer after disclosing his interest and the purchase had been approved by a disinterested majority of the board, Andrews could have sold the rights to the Corporation at a profit.

b. 1. The Federal Securities Act prohibits sales of or offers to sell securities to the public in interstate commerce made by issuers and underwriters unless the securities are registered with the Securities and Exchange Commission. In this situation, the sale to Smith would not be covered by the Act. Although it would be a sale by an issuer and, even assuming it were made in interstate commerce, it would not be a public sale on the facts given since Smith, a sophisticated investor with a thorough knowledge of the Corporation's affairs, would not be deemed a member of the public for purposes of the Act. The sale to the public would be a public sale and in interstate commerce; hence, registration under the Act would be required.

2. Yes. The Federal Securities Act prohibits public sales of securities in interstate commerce made by issuers and underwriters. An underwriter, under the Act, is a person who acquires securities with a view to the public resale thereof. Hence, if Smith acquired the Omega stock with such an intention in mind and Omega knew of this intention, Omega should register the securities with the Securities and Exchange Commission before the sale to Smith.

3. Pre-emptive rights are the rights of existing shareholders to participate proportionately in new issues. Since treasury stock is stock previously issued and reacquired by the Corporation, such rights ordinarily do not apply to treasury stock. A Corporation, by the terms of its charter or bylaws may limit or restrict such rights. Since, in the given fact situation there were no such restrictions on such rights in Omega's case, its existing stockholders would have pre-emptive rights in the newly authorized unissued stock to be sold to the public but not in the treasury stock to be sold to Smith.

4. Yes. Under provisions of the Federal Securities Exchange Act and the rules promulgated thereunder, corporate insiders are prohibited from trading on inside information at the expense of stockholders who are not insiders. This liability may be enforced by civil suits brought against the offending insider by persons damaged by his insider trading. Here, Baxter, by virtue of his position as a director was an insider and privy to infor-

mation affecting the value of the Corporation's stock which was not available to public stockholders. Thus, any such stockholder who sold stock to Baxter under these circumstances would have a cause of action against him.

5. Yes. The Federal Securities Exchange Act prohibits corporate insiders from realizing profit on short swing transactions in the Corporation's stock. A short swing transaction is a purchase and sale (or a sale and purchase) of stock within a six-month period. Here, Jones purchased and sold stock within a six-month period and is accountable to the Corporation for any profit he made as a result thereof.
6. When the management of a Corporation neglects or refuses to prosecute actions the Corporation may have against its officers or directors, such actions may be prosecuted on behalf of the Corporation by its shareholders by derivative suits. Since such suits are brought to enforce rights belonging to the Corporation, any recovery is for the Corporation's benefit and not for the benefit of the prosecuting stockholders.

Answer 5

a. 1. The negligence of Carter or of its employees would be no defense on Carter's fire policy with Phoen since such policies, ordinarily, insure against loss even when caused by the negligence of the insured. If the fire loss were occasioned by active wrongdoing of the insured, the policy would have been breached. However, on the facts given, there was no active wrongdoing by Carter and, hence, the insurer must pay the claim.

2. Phoen will have to pay Alpha Bank $100,000 on its policy with Alpha, that being the unpaid balance due Alpha on its mortgage at the time of the loss. After Phoen pays Alpha, Phoen will become subrogated to Alpha's claim in that amount against Carter on the mortgage. By virtue of the acceleration clause in the mortgage, this claim became immediately enforceable at the time of the loss. Carter's actual loss from the fire was $180,000. Although Carter carried insurance in the amount of $200,000, it cannot recover more than its actual loss, or $180,000. Moreover, since, as discussed above, Phoen would be subrogated to Alpha's claim against Carter on the mortgage in the amount of $100,000, Phoen would thus ultimately be required to pay Carter $80,000.

3. No. To enforce a claim under a policy of property insurance (such as a fire insurance policy), the insured must have an insurable interest in the property at the time the loss is suffered. The interest of a creditor in the security for his debt is an insurable interest. Hence, so long as any part of Alpha's mortgage loan remained upaid it had, to that extent, an insurable interest in Carter's plant. This interest ceased, however, when the mortgage debt was fully paid. Thus, Alpha would have no enforceable claim under its policy with Phoen if, prior to the loss, Carter's mortgage had been fully paid. In such a case, however, Alpha would be entitled to a refund of premiums it had paid for the period subsequent to extinguishment of the mortgage debt.

b. 1. No. When the insured misrepresents or fraudulently misstates material facts on his application for life insurance, the insurer may have a defense on the policy. A material fact would be a fact which, if known to the insurer, would affect its decisions whether or not to accept the risk and the terms and conditions under which it might be willing to accept the risk. However, by virtue of the incontestability clause, such a defense may not be raised by the insurer after the policy has been in force for the stipulated period, here two years. Accordingly, although Martin's misrepresentation may have been of a material fact and may otherwise have provided the insurer with a defense on the policy, this defense became unavailable after the lapse of the two-year period.

2. No. The insurable interest requirement in life insurance law requires that the person effecting the insurance (the insured) have an interest, usually an economic one, in the life of the person on whose life the policy is written at the time the insurance is effected. The insured obviously has such an interest in his own life. There is no requirement that the beneficiary of the policy have such an interest. Here, the insured was Martin. Williams was the beneficiary and he did not have to have an insurable interest in Martin's life to enforce the policy.

3. No. If Williams had taken out the policy he would be required to have an insurable interest in Martin's life at the time the policy was taken out. On the facts, Williams, as Martin's business partner at the time the insurance was effected, would have had such an interest. Although at the time of Martin's death Williams, presumably, no longer had such an interest since he and Martin were no longer partners, the law does not require that the interest exist at the time of death so long as such an interest existed at the time the policy was written. Hence, Williams could enforce the policy.

4. No. Lack of insurable interest is not covered by the incontestability clause. This clause only covers misrepresentations and fraud in connection with the insurance policy. Lack of an insurable interest is always available as a defense to the insurer.

5. No. Life insurers have no right of subrogation even when, as here, the insurer has paid a claim for death caused by the negligence of another. (Subrogation means that on payment of the insured's claim the insurer succeeds to his rights, if any, against third persons who may have caused the loss. Only under property insurance law is the insurer usually subrogated to the rights of the insured against third persons causing the loss.)

Answer 6

a. Sanitary Plumbing is liable to the creditors. The facts clearly indicate that the purchase by Sanitary Plumbing of Valvo Plumbing's assets was a bulk transfer. As a bulk purchaser, Sanitary Plumbing was obligated to demand and obtain a list of the creditors of the bulk seller and give notice to them. Since no notice was given to any creditors (at least ten days prior to taking possession), the sale is ineffective against them. In effect, the creditors of the bulk seller have the right to demand of the bulk buyer either the return of the property or a money equivalent.

b. Yes. The Uniform Commercial Code provides a new concept known as "cure." Its purpose is to prevent surprise or unwarranted rejections by buyers. When the seller notifies the buyer of his intent to cure the defects indicated and does so within the time provided to perform the contract, the seller is entitled to the same rights he would have had if he had rightfully performed initially. Therefore, Franks, having effectively cured his performance within the time permitted, would be able to recover damages from Acme for breach of contract.

c. 1. Typewriter Supply has anticipatorily repudiated its contractual obligation. It has done so by clearly indicating its intention not to perform at a time when such performance was not yet due. Furthermore, its failure to perform would substantially impair the value of the contract to Harper.

2. As a result of the anticipatory repudiation by Typewriter Supply, Harper may resort to several rights and remedies.

First, Harper may, if it wishes, await performance for a commercially reasonable time despite repudiation.

As an alternative course of action, Harper may resort to any remedy normally available for breach of contract including the right to "cover" (see below). This is so even though Harper notified Typewriter Supply that it would await the latter's performance and urged retraction of the repudiation.

In either case Harper would be entitled to suspend its own performance.

3. Harper is entitled to $1,875 damages. When a buyer chooses to cover, i.e., procure similar goods in the open market, his actual damages become the difference between the actual cost of replacement and the contract price. This choice to cover on the buyer's part must be reasonable and made in good faith. So long as this test is met, the buyer is entitled to the above recovery even though it is not the least expensive course of action.

Answer 7

a. 1. Yes. If a bank wrongfully dishonors a customer's check it is liable for damages "proximately caused" thereby. Where, as here, such wrongful dishonor is occasioned by mistake, the customer must, however, prove actual damages. That is, the loss must normally be a loss of money as contrasted with a loss of financial reputation.

2. Yes. Such damages would be consequential damages. In a proper case consequential damages may be recovered from a bank wrongfully dishonoring a check. To recover, however, the customer must prove the damages. If the Bank was on notice of the possible consequences of a wrongful dishonor, damages for such consequences should be recoverable.

3. There would be no liability to Nevins. He is merely an endorser seeking collection from the drawee bank (Cattlemen's). As such he has no contractual relationship with Cattlemen's Bank and cannot recover anything from the Bank. The only party having the right to recover for damages occasioned by a wrongful dishonor is the customer-drawer of the bank which dishonored the check.

b. 1. No. Although Granger and Fox were endorsers and thus contracted with subsequent holders (here Hines) that the check would be paid, to hold them liable Hines would be required to give the endorsers prompt notice of dishonor (within three business days) after the check was first dishonored. Hines' failure to do so released prior endorsers.
2. No. Endorsers are liable, as between themselves, in the order in which they sign. Granger made no contract with Fox and hence, is not liable to Fox.
3. Recovery could be had against Granger but not against Fox. As an unqualified endorser Granger contracted to pay on default. Fox's endorsement however was a qualified endorsement and he made no such contract. He has by his endorsement, "without recourse," eliminated liability as a surety on the check.
4. No. In the case of a check the Bank is chargeable, as to prior endorsers, with knowledge of the genuineness of its customer's (here Owens') signature. Hence, the endorsers' warranties as to the genuineness of the signature do not run to the Bank.

Answer 8

a. Yes. It is quite common for an accounting firm to develop special skills in a certain industry or type of business and there is nothing legally or ethically improper in one CPA firm's performing the audits for competing companies. There is normally little likelihood of a conflict of interest. Naturally, however, the firm owes a duty of loyalty to each of its clients and must not in any way breach its duty to one of its clients to aid another.

b. No. Supplying confidential information obtained from the records of Famous to Excellent to compare the performance of Famous and Excellent would be a breach of the duty which the Mio firm owes to Famous. Because the information is confidential, Famous would obviously not want it circulated, especially to competing firms. While information on published financial reports could be considered, no other information should be used without an express authorization from Famous.

c. Ross, Smith and Lewis will bear the loss. When one acts in an agency capacity and receives funds belonging to his principal, the law prohibits the agent from commingling such funds. Failure to obey this mandate imposes an insurer's liability upon the agent. That is, the agent will be liable without fault. Here, the CPA firm was neither dishonest nor negligent. However, due to this absolute prohibition against commingling of funds, the CPA firm is liable even though the loss was not due to its fault.

d. Yes. Normally a CPA firm will not be liable to third parties with whom it has neither dealt nor for whose benefit its work was performed. One notable exception to this rule is fraud. When the financial statements were fraudulently prepared, liability runs to all third parties who relied upon the false information contained in them. Fraud can be either actual or constructive. Here, there was no actual fraud on the part of Small or the firm in that there was no deliberate falsehood made with the requisite intent to deceive. However, it would appear that constructive fraud may be present. Constructive fraud is found where the auditor's performance is found to be grossly negligent. That is, the auditor really had either no basis or so flimsy a basis for his opinion that he has manifested a reckless disregard for the truth. Small's disregard for standard auditing procedures would seem to indicate such gross negligence and, therefore, would amount to constructive fraud. Where constructive fraud is found, the firm is liable to third parties who relied on the financial statements and suffered a loss as a result.

THEORY OF ACCOUNTS

November 7, 1969; 1:30 p.m. to 5:00 p.m.

Answer 1

1.	b	11.	a
2.	c	12.	c
3.	a	13.	d
4.	b	14.	c
5.	d	15.	b
6.	d	16.	b
7.	a	17.	a
8.	c	18.	b
9.	d	19.	c
10.	d	20.	d

Answer 2

a. A firm may wish to construct its own fixed assets rather than acquire them from outsiders to utilize idle facilities and/or personnel. In some cases fixed assets may be self-constructed to effect an expected cost saving. In other cases the requirements for the asset demand special knowledge, skills, and talents not readily available outside the firm. Also, the firm may want to keep the manufacturing process for a particular product as a trade secret.

b. Costs which should be capitalized for a self-constructed fixed asset include all direct and indirect material and labor costs identifiable with the construction. All direct overhead costs identifiable with the asset being constructed should also be capitalized. Examples of costs elements which should be capitalized during the construction period include charges for licenses, permits and fees, depreciation of equipment used in the construction, taxes, insurance, and similar charges related to the assets being constructed.

c. 1. The increase in overhead caused by the self-construction of fixed assets should be capitalized. These costs would not have been incurred if the assets had not been constructed. This proposition holds regardless of whether or not the plant is operating at full capacity. It is improper to increase the cost of finished goods with costs which were not incurred in their manufacture and which would not have been incurred if fixed assets had not been produced. However, if the total construction costs on self-constructed fixed assets were substantially in excess of their business and economic usefulness, the excess cost should not be capitalized but should instead be recorded as a loss.

2. It is clear that the capitalized costs of self-constructed assets should include a proportionate share of overhead on the same basis as that applied to goods manufactured for sale when the plant is operating at full capacity at the time the fixed asset is constructed. Under these circumstances costs of finished goods produced should not be increased for overhead for goods for which production was foregone. The activity replacing the production of goods for sale should be charged with the related overhead.

When idle plant capacity is used for the construction of a fixed asset, opinion varies as to the propriety of capitalizing a share of general factory overhead allocated on the same basis as that applied to goods manufactured for sale. The arguments to allocate overhead maintain that constructed fixed assets should be accorded the same treatment as inventory, new products, or joint products. It is maintained that this procedure is necessary, or special favors or exemptions from undercosting of fixed assets will cause a consequent overcosting of inventory assets.

Those arguing against allocating overhead to fixed assets where the assets are constructed when idle capacity exists maintain that since normal production will not be affected or overhead increased, capitalization will result in increased reported income for the period resulting from construction rather than production of goods for sale. It is also sometimes maintained that the full cost of the constructed asset should not include overhead that would be incurred in the absence of such construction.

d. The $90,000 cost by which the initial machine exceeded the cost of the subsequent machines should be capitalized. Without question there are substantial future benefits expected from the use of this machine. Because future periods will benefit from the extra outlays required to develop the initial machine, all development costs should be capitalized and subsequently associated with the related revenue produced by the sale of products manufactured. If, however, it can be determined that the excess cost of producing the first machine was the result of inefficiencies or failures which did not contribute to the machine's successful development, these costs should be recognized as an extraordinary loss. Subsequent periods should not be burdened with charges arising from costs which are not expected to yield future benefits.

Capitalizing the excess costs as a cost of the initial machine can be justified under the general rules of asset valuation. That is, an asset acquired should be charged with all costs incurred in obtaining the asset and placing it in productive use. A case could also be made for prorating the excess cost of developing the first machine equally to all four machines on the grounds that these costs were necessary in order to obtain the four machines. In this case, the acquisition of the four machines is analogous to a "basket" purchase where proration is acceptable.

Although less supportable, another alternative treatment of the excess costs of developing the initial machine is to capitalize the costs as research and development. The costs should nevertheless be amortized over the expected useful life of the initial machine.

Answer 3

a. 1. From the point of view of the issuer, the conversion feature of convertible debt results in a lower cash interest cost than in the case of nonconvertible debt. In addition, the issuer in planning its long-range financing may view the convertible debt as a means of raising equity capital over the long term. Thus, if the market value of the underlying common stock increases sufficiently after the issue of the debt, the issuer will usually be able to force conversion of the convertible debt into common stock by calling the issue for redemption. Under these market conditions the issuer can effectively eliminate the debt. On the other hand if the market value of the common stock does not increase sufficiently to result in the conversion of the debt, the issuer will have received the benefit of the cash proceeds to the scheduled maturity dates at a relatively low cash interest cost.

2. The purchaser obtains an option to receive either the face amount of the debt upon maturity or the specified number of common shares. If the market value of the underlying common stock increases above the conversion price, the purchaser (either through conversion or through holding the convertible debt containing the conversion option) receives the benefits of appreciation. On the other hand, should the value of the underlying company stock not increase, the purchaser could nevertheless expect to receive the principal and (lower) interest.

b. 1. The view that separate accounting recognition should be accorded the conversion feature of convertible debt is based on the premise that there is an economic value inherent in the conversion feature or call on the common stock and that the value of this feature should be recognized for accounting purposes by the issuer. It may be argued that the call is not significantly different in nature from the call contained in an option or warrant, and its issue is thus a type of capital transaction. The fact that the conversion feature coexists with certain senior security characteristics in a complex security and cannot be physically separated from these elements or from the instrument does not constitute a logical or compelling reason why the values of the various elements should not receive separate accounting recognition. The fact that the eventual outcome of the option granted the purchaser of the convertible debt cannot be determined at date of issuance is not relevant to the question of effectively reflecting in the accounting records the various elements of the complex document at the date of issuance. The conversion feature has a value at date of issuance and should be recognized. Moreover, the difficulties of implementation are not insurmountable and should not be relied upon to govern the conclusion.

2. The most important reason given in support of treating convertible debt as a single element is the inseparability of the debt and equity characteristics. The options provided by a convertible security cannot be physically separated and cannot, as a practical matter, exist independently. An investor ordinarily cannot sell one right and retain the other. Moreover, the option represents two mutually exclusive choices, which cannot both be consummated.

   Another argument in favor of accounting for convertible debt as a single element is that the valuation of the conversion privilege presents practical problems. In the absence of separability, fair values are not established in the marketplace, and, accordingly, values assigned to either the debt or equity features are necessarily subjective.

c. The method used by the company to record the exchange of convertible debentures for common stock can be supported on the grounds that, when the company issued the convertible debentures the proceeds could, to a larger extent, represent consideration received for the stock. Therefore when conversion occurs, the book value of the obligation is simply transferred to the stock exchanged for it.

On the other hand, recording the issue of the common at the book value of the debentures is open to question. It may be argued that the exchange of the stock for the debentures completes the transaction cycle for the debentures and begins a new cycle for the stock. The consideration or value used for this new transaction cycle should then be the amount which would be received if the debentures were sold rather than exchanged or the amount which would be received if the related stock were sold, whichever is more clearly determinable at the time of the exchange. This method recognizes changes in property values which have occurred and subordinates a consideration determined at the time the debentures were issued. The entries which would be used to record the exchange using the market values of the debentures and the stock for valuation purposes would be:

	Debenture Value		*Stock Value*	
Bonds payable	$100,000		$100,000	
Bond conversion cost	6,500		14,500	
Bond discount		$ 2,500		$ 2,500
Common stock		80,000		80,000
Premium on common stock		24,000		32,000

In this instance the market value of the debentures ($104,000) is the consideration received for the stock issued, and inasmuch as the firm is bound by the bondholders' option to convert, the $8,000 excess of the market value of the stock ($112,000) over the market value of the bonds may be viewed as an opportunity cost of the funds borrowed.

Answer 4

a. Firms maintain inventories to have flexibility in manufacturing operations and to be able to supply customers' immediate demands for products. The absence of inventory would require that the events of acquisition, transportation, manufacture, and sale of all products be so synchronized that the entire sequence could be completed in the same day initiated. If demand is seasonal, finished goods must be stockpiled in advance unless production is allowed to fluctuate. If a customer is unwilling to accept the delay necessary for the firm to acquire a product demanded, the firm must have the product on hand to fill demand or forego the opportunity of making the sale.

Moving goods from one location to another gives rise to inventories in transit. The time required to complete the manufacture of a product gives rise to in-process inventory. The co-ordination of varying manufacturing activities often gives rise to temporary stockpiles of goods or organized inventory. The inability or impracticability of synchronizing the acquisition or production of goods with demand gives rise to goods on hand, such as seasonal inventories. The economic requirements of often acquiring, producing and selling goods in batches produce temporary stockpiles of goods on hand. Finally, goods on hand in the form of buffer stocks are maintained as a defense against the uncertainty of future acquisitions, deliveries, or demand.

b. 1. In the order cycling system, the status of quantities on hand of each item or class is reviewed at predetermined periodic intervals. High value items and items critical to production usually require a short review cycle. Conversely, low value items and items noncritical to production may have a longer review cycle. At each review period orders are placed to bring quantities up to some determined and desired level.

The order cycling system is appropriate when the cost of continuous inventory status surveillance is high or when transportation and ordering economies may be gained through regular ordering of several different items from the same supplier.

2. In a min-max system, a maximum, which usage requirements normally will not exceed, is established for each item as well as a minimum to provide the margin of safety necessary to prevent stockouts during a reorder cycle. The minimum level sets the reorder point and the quantity to order is usually that quantity which will bring inventory up to the maximum level.

The min-max system is appropriate where cost of continuous inventory status surveillance is not high or where significant transportation and ordering economies may not be gained through regular ordering.

c. 1. The factors which should be considered in determining optimum inventory investment include balancing the total costs of carrying inventory with the total costs of not carrying enough inventory or stockouts.

The costs of carrying inventory which usually appear on formal accounting records include obsolescence and deterioration, taxes and insurance, and warehousing and storage. In addition, the interest or return on investment, a factor which normally does not appear in the accounting records, must be considered.

The costs of stockouts which often appear in accounting records include disruptions of production with extra costs of expediting, overtime, setup, hiring, and training; extra costs of uneconomic production runs; and extra purchasing and transportation costs. Costs of stockouts which frequently do not appear in accounting records include foregone quantity discounts, contribution margins on sales which might have been made, loss of customer goodwill, and foregone fortuitous purchases.

2. The principal factors to be considered in computing economic order quantity are: (1) cost of carrying an item in inventory, as described above, (2) the cost of placing an order, and (3) the quantity used.
3. The factors to be considered in establishing a minimum stock reorder point include: (1) lead time required to obtain the item, (2) the economic order quantity, and (3) average usage. The reorder point is commonly computed as safety stock plus the average usage during the lead time.

   The determination of safety stocks depends upon demand forecasts. In determining the size of safety stocks, the annual cost of stockouts, which depends upon the probability and the cost of a stockout, should be considered.

d. The principal advantage of stabilizing production by a manufacturer of a durable seasonal product is that costs of production may be decreased. For example, overtime premium pay may be reduced, maximum plant capacity does not have to be as large, costs of hiring and training new staff may be reduced, and costs incurred through the use of inexperienced temporary labor may be curtailed.

The disadvantages of stabilizing production include the costs of carrying additional inventory, losses from deterioration and obsolescence, and increased risk of inadequate demand since total demand must be anticipated on a long-term basis.

Answer 5

a. Capital budgeting is long-term planning with the use of quantitative data for making and financing proposed capital outlays with the objective of maximizing the long-term profitability of the firm. While the typical operating budget projects the details of the firm's activities over near-term fiscal periods, the capital budget considers the longer-range future. Capital budgeting techniques are most often applied to decisions involving the investment in plant and equipment items.

b. 1. The payback period method ranks investments according to the length of time required for them to generate an amount of cash equal to their costs. The major advantage of this method is that it is simple and almost universally understood. The chief limitation is that it emphasizes liquidity and tends to disregard profitability.

Use of the payback method is most appropriate when precision in estimates of profitability is not crucial, a weak cash and credit position has a heavy bearing on the selection of investment possibilities or considerable risk is involved in the proposed project.

2. The unadjusted accounting rate of return method provides a single measure of profitability. The rate of return is determined by dividing the project's average income by either its original investment or the average undepreciated cost of the project. In averaging earnings this method ignores the time value of money and the fact that earnings may be realized in uneven flows.
3. The discounted cash-flow method focuses on cash inflows and outflows rather than on net income. Because it considers the time value of money and uneven cash flows, the discounted cash-flow method is considered the most reliable technique for capital budgeting decisions. However, the discounted cash-flow method is more complex and is less widely understood than the payback or unadjusted accounting rate of return methods.

c. 1. The time-adjusted rate of return method is used when the cost of the investment and annual cash inflows are known and the rate of earnings is to be determined. The time-adjusted rate is the rate which equates the present value of the projected future net cash flows with the cost of the investment which produces them.

The investments are ranked according to their projected rates of return. An investment with a rate of return greater than the firm's desired rate of return would be acceptable and an investment with a return less than the desired rate of return would be rejected.

Because the rate of return is a ratio, however, it does not consider the amount of the investment in ranking projects. Thus it is difficult to use in choosing between competing projects requiring different amounts of cash investments. An implicit assumption of this method is that all net cash inflows from the projects under consideration can be reinvested at the respective computed rates of return.

2. The net present value method seeks to determine whether the present value of estimated future cash inflows at a desired rate of return will be greater or lesser than the cost of the proposed investment. With this method the cash inflows, initial investment, and desired rate of return are predetermined. The present value of the cash inflows and its difference from the initial investment are calculated. An investment would be acceptable if its net present value is positive. Investment proposals are ranked by net present values and the proposal with the highest net present value should be chosen. An implicit assumption of this method is that all net cash inflows can be reinvested at the rate used in computing net present value.

d. Cost of capital refers to an over-all cost of obtaining investment funds. While different techniques may be used in the computation of cost of capital, it is generally agreed that a cost factor should be assigned to both debt and to all stockholders' equity (including retained earnings). Some authorities suggest using a weighted average cost of capital for capital budgeting purposes.

Cost of capital is the desired or target rate of return used in the net present value method of discounted cash-flow computations. It is also the minimum acceptable (cut-off) rate used in choosing between projects employing the time-adjusted rate of return discounted cash-flow method.

e. The statistical term "expected value" describes the numerical average of a probability distribution of estimated future cash receipts from a capital budgeting project. This method is employed to estimate the most likely amount of future cash receipts by (1) estimating the various amounts of cash receipts from the project each year under different assumptions or operating conditions, (2) assigning probabilities to the various amounts estimated for each year and (3) determining the mean value of the estimated receipts for each year. The expected present value of all future receipts could then be determined by summing the expected discounted values of all years.

Answer 6

a. It is desirable to present in annual and other financial reports comparative financial statements and other historical, statistical-type summaries of financial data for a number of periods because such presentations enhance the usefulness of financial reporting and bring out more clearly the nature and trends of current changes affecting the enterprise. Such presentations emphasize the fact that statements for a series of periods are far more significant than those for a single period and that the report for one period is but an installment of what is essentially a continuous history.

Judiciously used, graphs and charts can be effective in highlighting the significant information for the reader. Visual presentations can be useful in reporting important relationships, assisting the reader in evaluating the progress of the enterprise, and portraying how the results affected the company's financial condition.

b. *Graph I*—This graph is misleading in two respects. First, because the percentages of sales increase for each segment of the business are placed on the top of one another in a vertical arrangement, the graph implies that the individual percentages could be summed to yield an increase in total sales from 1967 to 1969 of 385 per cent. In fact, total sales increased only 50 per cent.

Second, the growth in textiles sales is misleading because of its relatively small base. For example, an increase of $200,000 in textiles sales would have yielded a 100 per cent increase whereas an increase in chemical sales of $200,000 yielded only a 25 per cent increase.

The graph could be improved by placing the bars representing the individual divisions side by side on the graph and adding a bar for total sales. Finally, the base sales of the individual divisions should be disclosed, including the fact that the textiles division was formed in 1966.

Graph II—The rate of increase is exaggerated in Graph II, first because the sequence of sales figures is not constant, i.e., they go from zero to a $200 thousand variation (2,200 to 2,400) to a $100 thousand variation (2,500 to 2,600). Secondly, the distance between 1969 and 1968 is one-half the distance between 1967 and 1968, causing the angle of the 1969 growth line to be sharper and suggesting a greater rate of increase in sales than was actually experienced.

To remedy the graph's deficiencies, the scale should be complete, or at least it should be indicated that the bottom has been cut off. More importantly, the graph should be improved by making the sales figures increase by the same amount and by spacing the years equally.

Graph III—The bars in Graph III lack proportional size. For example, the bars depicting sources of funds in 1967, 1968 and 1969 are taller than those depicting applications of funds in the respective years. The result is that the reader may conclude from the bar that more funds were provided in the two years represented than were applied.

In addition, the bars representing 1969 data appear to be approximately three times the height of those representing 1967 data and twice the height of the bars for 1968. As a result, the reader might expect the sources and applications of funds to be approximately two or three times higher in 1969 or about $800,000 to $900,000 when in reality the sources and applications of funds totaled only $580,000, less than twice the amount in 1967 and about 50 per cent more than in 1968.

A third weakness of the graph is that depreciation, depletion and amortization are depicted as a source of funds. To report depreciation, depletion and amortization as a source of funds is ill-advised since it implies that total funds will vary with the rate or method used for computation.

In constructing a more effective graph, the bars representing application of funds should be the same size as those representing sources of funds respectively. Second, the bars depicting 1969 data should be almost twice the height of those representing 1967 data and about 50 per cent taller than those for 1968. Finally, depreciation, depletion and amortization should not be listed as a source of funds but rather included as an adjustment in determining funds from operations.

Answer 7

a. Conclusions to be drawn from the six variances are:

1. Materials price credit variance—indicates that materials were purchased at a price below standard.
2. Materials quantity debit variance—indicates more materials were used in the product than called for by the standard.
3. Labor rate debit variance—indicates that the wage rate paid to production workers exceeded the standard.
4. Labor efficiency debit variance—indicates that more time was spent on production than was called for by the standard.
5. Manufacturing overhead controllable debit variance—indicates that the actual overhead exceeded the flexible budget for overhead at the level of activity attained or that the actual variable overhead exceeded the standard variable overhead.

6. Manufacturing overhead noncontrollable capacity debit variance—indicates an underutilization of capacity since actual fixed overhead exceeded the amount of fixed overhead absorbed by production.

   Of course the balance shown in each variance account does not mean that every transaction was above or below standard; the balance is a net of all charges and credits to the account.

b. The descriptions of the allocation bases and the theoretical arguments for each follow:
   1. *Ideal (or theoretical) capacity* is the maximum production which could be attained under specified operating conditions with no provision for any production interruptions, such as work stoppages or machine downtime for repair. The principal argument for this overhead allocation basis (and also the practical capacity basis) is that it does not assign the cost of idle or unused facilities to product under the theory that such costs add no value to product.
   2. *Practical capacity* is the maximum production which could be attained during normal operating hours with provision for normal downtime for machine repair. Such unavoidable idle time is anticipated and allowed for and is a legitimate cost of product. Normal downtime is as essential as materials or labor, and manufacturing cannot take place without some minimum amount.
   3. *Normal capacity* is the average annual production which will meet customer demand over enough years to include seasonal, cyclical, and trend variations in demand. The principal argument for this allocation basis is that idle facilities caused by these variations in demand is typical of many industries. It is unavoidable and anticipated and is a legitimate cost of production.
   4. *Expected annual capacity* is the estimated production determined each year for the coming year. Most authorities offer no theoretical support for this basis. It is sometimes used and may be justified as a practical alternative to *normal capacity* when estimates of normal are unavailable. Most authorities would exclude the cost of excess (unwanted) capacity from the rate.

c. The theoretical justification for each of the described methods of accounting for the annual net amount of standard cost variance follows:
   1. Presenting the net variance as a charge or credit on the income statement indicates that it is regarded as an appropriate charge or credit in the period in which it arises because it is considered to be the result of favorable or unfavorable departures from normal (standard) conditions. The variance should be disclosed separately from cost of goods sold at standard and thus provide management with unobscured information permitting immediate corrective action. Inventory valuations and cost of goods sold should not be distorted by variances which represent abnormal efficiences or inefficiencies. Standard cost represents that amount which is reasonably necessary to produce finished products and should therefore be considered the best measure of cost of goods manufactured and inventory valuation as long as the underlying operating conditions remain unchanged.

2. Those who advocate allocation of the net variance among inventories and cost of goods sold regard standard costs as a useful tool for purposes of managerial control, not as substitutes for actual historical costs in the financial statements. They believe that only actual historical costs should be used for financial reporting, even though they are greater or less than standard costs and without regard to the reasons for their differences from standard costs. Standard cost variances are not gains or losses but cost (or reductions therein) of goods manufactured and, as such, should be allocated among inventories and cost of goods sold; to treat them otherwise distorts both the inventory and gross profit. This distortion would be even greater if the standards were carelessly determined and are lacking in accuracy or reliability. Further, to substitute standard costs for actual historical costs in the financial statements represents an unwarranted sacrifice of objectivity.
3. Presenting the net variance as an adjustment to cost of goods sold indicates that the charge or credit should be included in the period during which it occurs and that it should be identified with manufacturing costs rather than with other operating costs. This presentation is appropriate only if the variance is not material in relation to the total cost of goods manufactured or if there are no ending inventories, since it would otherwise distort gross profit.

Solutions and Answers to Examination
May 1970

ACCOUNTING PRACTICE—PART I

May 6, 1970; 1:30 to 6:00 p.m.

Solution 1

1. a	11. a
2. b	12. b
3. b	13. e
4. d	14. d
5. e	15. c
6. b	16. a
7. c	17. a
8. b	18. a
9. e	19. c
10. c	20. c

Solution 2

a.

Vernon Enterprises
SCHEDULE OF PROBABLE SALES OF NEW TOY

Sales if Demand is:		*Probability*	*Year 1*	*Year 2*	*Year 3*
Above average:					
Year 1	$1,200,000	.30	$360,000		
Year 2	2,500,000	.30		$ 750,000	
Year 3	600,000	.30			$180,000
Average:					
Year 1	$ 700,000	.60	420,000		
Year 2	1,700,000	.60		1,020,000	
Year 3	400,000	.60			240,000
Below average:					
Year 1	$ 200,000	.10	20,000		
Year 2	900,000	.10		90,000	
Year 3	150,000	.10			15,000
Total probable sales			$800,000	$1,860,000	$435,000

b.

Vernon Enterprises
SCHEDULE COMPUTING PROBABLE NET INCOME FOR NEW TOY

	Years 1	2	3
Probable sales	$ 900,000	$1,800,000	$ 410,000
Contribution rate	.70	.70	.70
Contribution to fixed expenses and profits	630,000	1,260,000	287,000
Deduct: Advertising	(100,000)	(150,000)	(50,000)
Depreciation	(375,000)	(250,000)	(125,000)
Other fixed expenses	(50,000)	(50,000)	(50,000)
Taxable income	105,000	810,000	62,000
State and federal income taxes (60%)	63,000	486,000	37,200
Probable net income	$ 42,000	$ 324,000	$ 24,800

c.

Vernon Enterprises
SCHEDULE OF NET CASH FLOWS FOR NEW TOY

	Years 0	1	2	3	4
Cost of machine	($860,000)				
Net income		$ 42,000	$324,000	$ 24,800	
Depreciation		375,000	250,000	125,000	
Proceeds from sale of machine					$110,000
Net cash flow	($860,000)	$417,000	$574,000	$149,800	$110,000

d.

Vernon Enterprises
SCHEDULE OF PRESENT VALUE OF NET CASH FLOWS FOR NEW TOY

	Years 0	1	2	3	4
Uniform cash flows:					
Operations		$417,000	$574,000	$149,800	
Lump-sum cash flows:					
Cost of machine	($860,000)				
Proceeds from sale of machine					$110,000
Discount factor	1.00	.95	.86	.78	.75
Net present value of cash flows	($860,000)	$396,150	$493,640	$116,844	$ 82,500

Solution 3

a.

Weinstein Contractors, Inc.

SCHEDULE TO COMPUTE PERCENTAGE OF COMPLETION OF CONTRACTS IN PROGRESS

December 31, 1969

Contract	*Estimated Costs*	*Costs Incurred to Date*	*Percentage of Completion*
1	$199,000	$115,420	58%
2	40,000	32,000	80
3	313,700	313,700	100

b.

Weinstein Contractors, Inc.

SCHEDULE TO COMPUTE EARNED INCOME TO BE RECOGNIZED IN 1969 FROM CONTRACTS IN PROGRESS

	Total	*Contract 1*	*Contract 2*	*Contract 3*
Total estimated contract price	$626,000	$239,000	$43,000	$344,000
Percent complete		58%	80%	100%
Revenue earned to date	517,020	138,620	34,400	344,000
Revenue recognized in 1968	47,800	47,800*		
Revenue earned in 1969	469,220	90,820	34,400	344,000
Cost of revenue earned in 1969	421,320	75,620**	32,000	313,700
Net income from construction	$ 47,900	$ 15,200	$ 2,400	$ 30,300

*Total contract price	$239,000
Percentage of completion	20%
Revenue recognized in 1968	$ 47,800

**Total cost incurred to date	$115,420
Cost incurred in 1968	39,800
Costs incurred this period	$ 75,620

c.

Weinstein Contractors, Inc.
SCHEDULE TO COMPUTE FEDERAL INCOME TAX PROVISION AND LIABILITY
For 1969

Net income from construction contracts	*Accounting Income*	*Taxable Income*
Contract 1	$15,200	None
Contract 2	2,400	None
Contract 3	30,300	$30,300
	47,900	30,300
Selling and administrative expenses	20,600	20,600
Net operating loss carryforward		3,230
Reported net income before taxes	$27,300	$ 6,470
Provision for federal income taxes (.40 x $27,300)		$10,920
Federal income taxes payable currently (.40 x $6,470)		2,588
Deferred		$ 8,332

Computation of Operating Loss Carryforward

Net income from Contract 1 for 1968	$ 8,000
Net income of Corporation for 1968 (1,908 ÷ .40)	4,770
Net operating loss carryforward (selling and administrative expenses for 1968)	$ 3,230

d. **Weinstein Contractors, Inc.**
ADJUSTING JOURNAL ENTRIES

Billings on contracts in progress	$469,220	
Revenues from construction		$469,220
To record revenue to be recognized under percentage of completion method.		
Cost of recognized revenues	421,320	
Costs of contracts in progress		421,320
To recognize cost of revenues recognized under the percentage of completion method.		
Provision for federal income taxes	10,920	
Federal income taxes payable currently		2,588
Deferred income taxes		8,332
To record tax accrual.		

Solution 4

Brighton Corporation and Subsidiary
WORKSHEET FOR PREPARATION OF CONSOLIDATED BALANCE SHEET
December 31, 1969

	Brighton Corporation	Solvo Corporation	Adjustments and Eliminations Debit		Adjustments and Eliminations Credit		Consolidated Balance Sheet Debit	Consolidated Balance Sheet Credit
Assets								
Cash	$ 200,000	$ 20,000					$ 220,000	
Accounts receivable	205,000	55,000			(3)	$ 18,500	241,500	
Notes receivable	180,000	11,000			(7)	4,000	187,000	
Notes receivable discounted	(4,000)		(7)	$ 4,000				
Accrued interest receivable	1,600	400			(6)	1,200	800	
Dividends receivable	6,400				(2)	6,400		
Inventories	300,000	75,000			(4)	8,000	367,000	
Plant and equipment	794,000	280,600	(5)	2,000			1,076,600	
Allowance for depreciation	(260,000)	(30,000)			(5)	90		$ 290,090
Investment in Solvo Corporation stock	167,400				(1)	167,400		
Investment in Solvo Corporation bonds	40,000				(6)	40,000		
Advance to Solvo Corporation	35,000				(8)	35,000		
	$1,665,400	$412,000						
Liabilities and Stockholders' Equity								
Accounts payable	$ 220,400	$ 54,800	(3)	18,500				256,700
Notes payable	142,000	24,200						166,200
Dividends payable		8,000	(2)	6,400				1,600
Accrued interest payable	22,100	3,900	(6)	1,200				24,800
Other accrued liabilities	7,900	3,100						11,000
Advance from Brighton Corporation		35,000	(8)	35,000				
Bonds payable	600,000	85,000	(6)	40,000				645,000
Capital stock	360,000	125,000	(1)	125,000				360,000
Capital in excess of par value	49,000	12,000	(1)	12,000				49,000
Retained earnings	264,000	61,000	(1)	61,000	(5)	1,910		258,910
			(4)	7,000				
	$1,665,400	$412,000						
Excess of cost over book value of subsidiary interest			(1)	9,000			9,000	
Minority interest in subsidiary			(4)	1,000	(1)	39,600		38,600
				$322,100		$322,100	$2,101,900	$2,101,900

Brighton Corporation and Subsidiary
ELIMINATION AND ADJUSTING JOURNAL ENTRIES
December 31, 1969
(Not Required)

(1)

Capital stock—Solvo		$125,000	
Retained earnings—Solvo		61,000	
Capital in excess of par value—Solvo		12,000	
Excess of cost over book value of subsidiary interest		9,000	
Investment in Solvo Corporation stock			$167,400
Minority interest in subsidiary			39,600
To eliminate investment account in subsidiary and set up minority interest.			

(2)

Dividends payable		6,400	
Dividends receivable			6,400
To eliminate intercompany accounts for subsidiary dividends declared but not paid (80% × $8,000).			

(3)

Accounts payable		18,500	
Accounts receivable			18,500
To eliminate intercompany receivables and payables ($13,000 + $5,500).			

(4)

Retained earnings		7,000	
Minority interest in subsidiary		1,000	
Inventories			8,000
To eliminate intercompany profit in inventory.			
Computation of intercompany profit in inventories:			
Sold by Solvo: $25,000 — ($25,000 ÷ 1.25)	$5,000		
Sold by Brighton: $18,000 — ($18,000 ÷ 1.20)	3,000		
Intercompany profit	$8,000		

(5)

Plant and equipment		2,000	
Retained earnings			1,910
Allowance for depreciation			90
To eliminate intercompany loss and adjust accumulated depreciation on equipment sold to Solvo by Brighton after acquisition of controlling interest.			

	Equipment	*Depreciation*
Brighton book value	$14,000	$630
Sales price	12,000	540
Excess	$ 2,000	$ 90

(6)

Bonds payable	$ 40,000	
Accrued interest payable	1,200	
Investment in Solvo Corporation bonds		$ 40,000
Accrued interest receivable		1,200
To eliminate intercompany bond holdings and accrued interest ($40,000 × 6% × ½).		

(7)

Notes receivable discounted	4,000	
Notes receivable		4,000
To eliminate intercompany notes discounted.		

(8)

Advance from Brighton Corporation	35,000	
Advance to Solvo Corporation		35,000
To eliminate intercompany advances.		

Solution 5

1. d
2. a
3. b
4. c
5. b
6. d
7. a
8. c
9. b
10. c
11. d
12. b
13. a
14. d
15. b
16. d
17. d
18. b
19. d
20. b

Solution 6

City of Waterford
WORKSHEET FOR FINANCIAL STATEMENTS*
December 31, 1969

	General Fund Trial Balance		Adjustments		General Fund		Bond Fund (Capital Projects Fund)	General Fixed Assets (General Fixed Assets Group of Accounts)	General Bonded Debt and Interest (General Long-Term Debt Group of Accounts)
	Debit	Credit	Debit	Credit	Debit	Credit			
Cash	$ 207,500			(4) $100,000	$ 107,500				
Taxes receivable—current	148,500				148,500				
Allowance for uncollectible taxes—current		$ 6,000				$ 6,000			
Appropriation expenditures	760,000				760,000				
Revenues		992,500	(3) $190,000			802,500			
Donated land	190,000			(3) 190,000					
River Bridge bonds authorized—unissued	100,000			(4) 100,000					
Work in process—River Bridge	130,000			(4) 130,000					
River Bridge bonds payable		200,000	(4) 200,000						
Contracts payable—River Bridge		25,000	(4) 25,000						
Retained percentage—River Bridge contracts		5,000	(4) 5,000						
Vouchers payable		7,500				7,500			
Surplus		300,000	(1) 200,000						
			(4) 100,000						
	$1,536,000	$1,536,000							

	Adjustments Debit	Adjustments Credit	General Fund Debit	General Fund Credit	Bond Fund (Capital Projects Fund)	General Fixed Assets (General Fixed Assets Group of Accounts)	General Bonded Debt and Interest (General Long-Term Debt Group of Accounts)
Estimated revenues	(1) 815,000		815,000				
Appropriations		(1) 775,000		775,000			
Unappropriated surplus (Fund balance)		(1) 240,000		240,000			
Encumbrances	(2) 2,500		2,500				
Reserve for encumbrances		(2) 2,500		2,500			
Cash—bond fund (Capital projects fund)	(5) 100,000				$ 100,000		
Construction expenditures—River Bridge	(5) 130,000				130,000		
(Revenues—River Bridge)		(5) 200,000			(200,000)		
Contracts payable—River Bridge		(5) 25,000			(25,000)		
Contracts payable—retained percentage—River Bridge contracts		(5) 5,000			(5,000)		
Land	(6) 190,000					$190,000	
Investment in general fixed assets—state grant-in-aid (Investment in general fixed assets—capital projects fund—state grant)		(6) 190,000				(190,000)	
Construction work in process—River Bridge	(7) 130,000					130,000	
Equipment	(7) 10,000					10,000	
Structures and improvements	(7) 210,000					210,000	
Investment in general fixed assets—general fund revenues		(7) 220,000				(220,000)	
Investment in general fixed assets—from bonds (Investment in general fixed assets—capital projects fund—general obligation bonds)		(7) 130,000				(130,000)	
Amount to be provided for retirement of River Bridge bonds	(8) 200,000						$ 200,000
River Bridge bonds payable		(8) 200,000					(200,000)
	$ 2,507,500	$ 2,507,500	$1,833,500	$1,833,500	$ —	$ —	$ —

*Note: Fund and account titles enclosed in parentheses are those currently recommended by the National Committee on Governmental Accounting and are used in cases where current recommendations differ from traditional terminology.

City of Waterford
ADJUSTING AND CLOSING JOURNAL ENTRIES*
December 31, 1970
(Not Required)

GENERAL FUND

(1)

Surplus	$200,000	
Estimated revenues	815,000	
Appropriations		$775,000
Unappropriated surplus (Fund balance)		240,000

To record budget for 1969 and to close the portion of the Surplus account applicable to the general fund.

(2)

Encumbrances	2,500	
Reserve for encumbrances		2,500

To record encumbrances for outstanding purchase orders.

(3)

Revenues	190,000	
Donated land		190,000

To remove accounts belonging to the General Fixed Assets.

(4)

Surplus	100,000	
Contracts payable—River Bridge	25,000	
Retained percentage—River Bridge contracts	5,000	
River Bridge bonds payable	200,000	
Cash		100,000
Work in process—River Bridge		130,000
River Bridge bonds authorized—unissued		100,000

To remove accounts belonging to other funds.

BOND FUND (CAPITAL PROJECTS FUND)

(5)

Cash—bond fund (Capital projects fund)	100,000	
Construction expenditures—River Bridge	130,000	
(Revenues—River Bridge)		200,000
Contracts payable—River Bridge		25,000
Contracts payable—retained percentage—River Bridge contracts		5,000

To segregate River Bridge bond transactions.

(5)—Alternate

Although an entry to record the bond authorization is not currently recommended by the National Committee on Governmental Accounting, it is required by some

*Note: Fund and account titles enclosed in parentheses are those currently recommended by the National Committee on Governmental Accounting and are used in cases where current recommendations differ from traditional terminology.

jurisdictions. The following entry includes the bond authorization:

Cash—bond fund (Capital projects fund)	$100,000	
Construction expenditures—River Bridge	130,000	
River Bridge bonds authorized—unissued	100,000	
Appropriations—River Bridge (Revenues—River Bridge)		$300,000
Contracts payable—River Bridge		25,000
Contracts payable—retained percentage—River Bridge contracts		5,000

GENERAL FIXED ASSETS (GENERAL FIXED ASSETS GROUP OF ACCOUNTS)

(6)

Land	190,000	
Investment in general fixed assets—state grant-in-aid (Investment in general fixed assets—capital projects fund—state grant)		190,000
To record donation of land by the state.		

(7)

Equipment	10,000	
Construction work in process—River Bridge	130,000	
Structures and improvements	210,000	
Investment in general fixed assets—general fund revenues		220,000
Investment in general fixed assets—from bonds (Investment in general fixed assets—capital projects fund—general obligation bonds)		130,000
To record investment in fixed assets financed from issuance of bonds and from current revenues.		

GENERAL BONDED DEBT AND INTEREST (GENERAL LONG-TERM DEBT GROUP OF ACCOUNTS)

(8)

Amounts to be provided for retirement of River Bridge bonds	200,000	
River Bridge bonds payable		200,000
To record projected liability for principal and interest of River Bridge bonds at the present discounted value of these future payments.		

(8)—Alternate

Although an entry to record the accrual of all interest payable in future years is not currently recommended by the National Committee on Governmental Accounting, the following entry is required by some jurisdictions:

Amount to be provided for payment of River Bridge bond interest	60,000	
Amount to be provided for retirement of River Bridge bonds	200,000	
River Bridge bond interest payable in future years		60,000
River Bridge bonds payable		200,000
To record the projected liability for principal and interest of River Bridge bonds.		

ACCOUNTING PRACTICE—PART II

May 7, 1970; 1:30 to 6:00 p.m.

Solution 1

Bledsoe Corporation
SCHEDULE OF TAXABLE INCOME
For Year Ended December 31, 1969

Gross sales	$847,500	
Less sales discount	6,500	
Net sales		$841,000
Cost of goods sold:		
Inventory, January 1, 1969	93,000	
Add purchases	677,000	
Cost of goods available for sale	770,000	
Less inventory, December 31, 1969	95,000	
Cost of goods sold		675,000
Gross profit		166,000
Operating expenses:		
General and administrative	103,600	
Repairs made on warranty contracts	3,200	
Depreciation	42,000	148,800
Net income before extraordinary items and adjustments		17,200
Add:		
Section 1245 gain on sale of warehouse equipment		1,500
Section 1245 gain on replacement of boiler		3,750
Total		22,450
Deduct:		
Section 1231 ordinary loss on sale of land ($11,500—$10,000)		1,500
Income taxable at ordinary rates		$ 20,950

Computation of Gross Sales

Collections on account	$756,500
Less accounts receivable, 12/31/68	62,000
Total	694,500
Add accounts receivable, 12/31/69	73,000
Sales on account	767,500
Add cash sales	80,000
Gross sales	$847,500

Computation of Purchases

Payments to trade creditors	$603,000
Less accounts payable, 12/31/68	191,000
Total	412,000
Add accounts payable, 12/31/69	205,000
Purchases on account	617,000
Add cash purchases	60,000
Total purchases	$677,000

Computation of General and Administrative Expense

Cash disbursements for general and administrative expenses		$102,000
Add:		
Prepaid expenses, 12/31/68	$4,800	
Accrued expenses, 12/31/69	4,500	9,300
Total		111,300
Less:		
Prepaid expenses, 12/31/69	4,200	
Accrued expenses, 12/31/68	3,500	7,700
General and administrative expenses		$103,600

Computation of Gain on Sale of Warehouse Equipment

Sales price		$ 6,000
Less:		
Cost of warehouse equipment	$12,500	
Less accumulated depreciation	8,000	4,500
Section 1245 gain on sale of warehouse equipment		$ 1,500

Computation of Gain on Replacement of Boiler

Insurance proceeds		$21,000
Cost	$24,000	
Less depreciation	10,000	
Book value		14,000
Gain		$ 7,000
Insurance proceeds		$21,000
Less cost of replacement		17,250
Section 1245 gain on replacement of boiler		$ 3,750

NOTE: $3,250 gain not recognized ($7,000—$3,750).

Solution 2

a.

Metal Industries, Inc.

SCHEDULE COMPUTING UNIT COSTS AND CONTRIBUTION MARGINS

	Parts Per Strip	*Weight Per Unit*	*Total*
Yield from each 4-foot length strip of metal:			
Large discs	4	4.0 oz.	16.0
Small discs	4	2.4 oz.	9.6
Balance—scrap			6.4
Each 4-ft. length weighs 2 lbs.			32.0 oz.
Cost per piece (4 ft. @ $1.36)			$5.44
Less scrap value @ 80¢ per lb. (or 5¢ per oz.): 6.4 oz. × 5¢ =			.32
Net cost of good material			$5.12
Divided by ounces of good material			25.6
Material cost per ounce			$ .20
1. Pro-rated material cost per unit:			
Large discs (4 oz. @ 20¢)			$ .80
Small discs (2.4 oz. @ 20¢)			$ .48

	Large Disc	*Small Disc*
Material cost	$ .80	$ .48
Variable conversion cost as a percentage of direct material cost	80%	75%
2. Amount allocated for conversion cost	.64	.36
Total variable cost per unit	$1.44	$ .84
Selling price per unit	$2.90	$1.40
Less total variable cost	1.44	.84
3. Contribution margin per unit	1.46	.56
Number of units sold	40,000	40,000
4. Total contribution margin	$58,400	$22,400

Proof of Unit Cost of Materials
(Not Required)

Large Discs (4 × 80¢)	$ 3.20
Small Discs (4 × 48¢)	1.92
Net cost of good material per metal strip	$ 5.12

Proof of Total Contribution Margin
(Not Required)

	Large Disc	*Small Disc*	*Total*
Number of units sold	40,000	40,000	
Selling price per unit	$ 2.90	$ 1.40	
Total sales price	$116,000	$56,000	$172,000
Cost price per unit	$ 1.44	$ .84	
Total cost price	$ 57,600	$33,600	91,200
Contributed margin per unit	$ 1.46	$ .56	
Total contribution margin	$ 58,400	$22,400	80,800
Less fixed costs			86,000
Net loss for the department			$(5,200)

Proof of Cost of Sales
(Not Required)

	Material Cost		*Conversion Cost*		*Less Scrap Value*		*Cost of Sales*
10,000 strips @ $5.44	$54,400				$3,200		
40,000 pieces @ 64¢ for large discs			$25,600				
40,000 pieces @ 36¢ for small discs			14,400				
	$54,400	+	$40,000	—	$3,200	=	$91,200

Computation of Scrap Value

10,000 strips @ 2 lbs. each = 20,000 lbs. × 20% scrap =
4,000 lbs. @ 80¢ per lb. = $3,200
or
10,000 strips @ 32¢ salvage value per strip = $3,200

b. **COMPUTATION OF BREAKEVEN OUTPUT**

$$\text{Breakeven output (units)} = \frac{\text{fixed costs}}{\text{contribution margin per unit}}$$

$$\text{Breakeven output} = \frac{\$86,000}{\$1.8775} = 45,806 \text{ units}$$

Unit Calculations

Product	*Sales Price*	*Material Cost*	*Conversion Cost*	*Total Costs*
Large Discs	$2.90	$.85	$.68	$1.53
Small Discs	1.40	.51	.3825	.8925
Totals	4.30			$2.4225
Total variable cost	2.4225			
Contribution margin per unit	$1.8775			

Proof
(Not Required)

Breakeven sales (45,806 × $4.30)		$196,965.80
Costs:		
Variable (45,806 × $2.4225)	$110,965.04	
Fixed	86,000.00	196,965.04
Gain		$ .76

Solution 3

a.

Plan 1

SCHEDULE TO ALLOCATE GENERAL OVERHEAD EXPENSES ON THE BASIS OF SALES VOLUME

Store	*Allocation %*	*General Overhead Expense*	*Income Before General Overhead Expense*	*Income After General Overhead Expense*
Ashville	40	$ 69,200	$ 84,800	$15,600
Burns	34	58,820	57,330	(1,490)
Clinton	26	44,980	52,552	7,572
	100%	$173,000	$194,682	$21,682

Computation of General Overhead Allocation Percentages Based on Sales Volume

Store	*Sales*	*Percentages*
Ashville	$ 416,000	40
Burns	353,600	34
Clinton	270,400	26
	$1,040,000	100%

Plan 2

SCHEDULE TO ALLOCATE GENERAL OVERHEAD EXPENSES ON VARIOUS BASES

			Store		
	Total	*Warehouse Operations*	*Ashville*	*Burns*	*Clinton*
Income before general overhead	$194,682		$84,800	$ 57,330	$52,552
Warehouse operations	$30,000	$30,000			
Allocated central office salaries	$ 37,000	9,250	9,250	9,250	9,250
Allocated other central office expenses	$ 28,000	7,000	7,000	7,000	7,000
Total warehouse operations	$ 46,250	$46,250			
Warehouse depreciation	20,000				
Advertising	18,000				
Total allocation based on sales volume	$ 84,250		33,700	28,645	21,905
Delivery expenses—allocated on basis of miles times deliveries	$ 40,000		16,800	12,800	10,400
Total general overhead	$173,000		66,750	57,695	48,555
Income (loss) after general overhead	$ 21,682		$18,050	$(365)	$ 3,997

Computation of General Overhead Allocation Percentages Based on Delivery Miles Times Number of Deliveries

Store	*Miles*	*Number of Deliveries*	*Miles × Number of Deliveries*	*Allocation Percentage*
Ashville	120	140	16,800	42
Burns	200	64	12,800	32
Clinton	100	104	10,400	26
			40,000	100%

b. Management should expand the Clinton Store because costs would increase least and net income would increase most using this alternative as shown by the computation presented below. (Differential revenues would be the same for all stores, but differential costs would be least at Clinton; differential net income, therefore, would be greatest at Clinton.)

Computation of Cost Increases Resulting From the Proposed Increase in Sales

	Ashville	*Burns*	*Clinton*	*Total*
Sales, net—1969	$416,000	$353,600	$270,400	$1,040,000
Cost of sales—1969	$215,700	$183,300	$140,200	$ 539,200
Local variable operating expenses	54,700	64,220	27,448	146,368
Total local variable costs	$270,400	$247,520	$167,648	$ 685,568
Percent of local variable costs to sales	65%	70%	62%	
Times anticipated sales increase	$ 50,000	$ 50,000	$ 50,000	
Increase in local variable costs	32,500	35,000	31,000	
Increase in delivery expenses	1,200	2,000	1,000	
Increase in relevant expenses (local variable costs and delivery expenses)	$ 33,700	$ 37,000	$ 32,000	

Computation of Increase in Delivery Expenses

Store	*Miles*	*Number of Deliveries*	*Number of Delivery Miles*	*Cost Per Delivery Mile*	*Total Increase in Delivery Expenses*
Ashville	120	10	1,200	$1.00	$1,200
Burns	200	10	2,000	1.00	2,000
Clinton	100	10	1,000	1.00	1,000

$$\text{Cost per delivery mile} = \frac{\text{Delivery expenses in 1968}}{\text{Delivery miles in 1968}} = \frac{\$40{,}000}{40{,}000} = \$1.00$$

Solution 4

a.

Skadden, Inc.

SCHEDULE TO ANALYZE EQUIPMENT FOR GENERAL PRICE-LEVEL RESTATEMENT

December 31, 1969

Year Acquired	*Amount (Historical)*	*Conversion Factor*	*Amount (General Price-Level)*
1967	$490,000	1.100	$539,000
1968	10,000	1.055	10,550
1969	150,000	1.014	152,100
	$650,000		$701,650

b.

Skadden, Inc.

SCHEDULE TO ANALYZE EQUIPMENT—ACCUMULATED DEPRECIATION (Historical Dollars)

For the Year 1969

Year Assets Acquired	*Balance 12/31/68*	*Depreciation for 1969*	*Retirements in 1969*	*Balance 12/31/69*
1967	$110,000	$49,000	$12,000	$147,000
1968	1,000	1,000		2,000
1969		15,000		15,000
	$111,000	$65,000	$12,000	$164,000

c.

Skadden, Inc.

SCHEDULE TO ANALYZE EQUIPMENT—ACCUMULATED DEPRECIATION (General Price-Level Dollars)

For the Year 1969

Year Assets Acquired	*Conversion Factor*	*Balance 12/31/68*	*Depreciation*	*Retirement*	*Balance 12/31/69*
1967	1.100	$121,000	$53,900	$13,200	$161,700
1968	1.055	1,055	1,055		2,110
1969	1.014		15,210		15,210
		$122,055	$70,165	$13,200	$179,020

d.

Skadden, Inc.

SCHEDULE TO COMPUTE GENERAL PRICE-LEVEL GAIN OR LOSS
For 1969

	12/31/68			12/31/69
	Historical	*Conversion Factor*	*Restated to 12/31/69 $'s*	*Historical (stated in 12/31/69 $'s)*
Net monetary items:				
Cash & receivables				$ 540,000
Accounts payable				(300,000)
Bonds payable				(500,000)
Net	$ 445,000	1.040	$462,800	$ (260,000)

			Restated to 12/31/69 $'s
General price-level gain or loss			
Net monetary items—12/31/69	$ 445,000	1.040	$ 462,800
Add: Sales	1,900,000	1.014	1,926,600
	2,345,000		2,389,400
Deduct:			
Purchases	1,840,000		
Operating expenses & interest	215,000		
Purchase of marketable securities	400,000		
Acquisitions of equipment	150,000		
	2,605,000	1.014	2,641,470
Net monetary items—historical	$ (260,000)		
Net monetary items—historical —restated—12/31/69			(252,070)
Net monetary items—12/31/69 (as above)			(260,000)
General price-level loss			$ (7,930)

Solution 5

a.

Superior Products, Inc.
SCHEDULE COMPUTING PREFERRED DIVIDENDS PAID
1965 Through 1969

		Number of Shares		*Dividends Paid*	
Year	*Half (1st or 2nd)*	*Purchased and Retired*	*Outstanding*	*Semiannually*	*Annually*
1965	1st		6,892*	$13,784	
	2nd		6,892	13,784	$27,568
1966	1st		6,892	13,784	
	2nd		6,892	13,784	$27,568
1967	1st		6,892	13,784	
	2nd		6,892	13,784	$27,568
1968	1st		6,892	13,784	
	2nd	32	6,860	13,720	$27,504
1969	1st		6,860	13,720	
	2nd	140	6,720	13,440	$27,160

*7,000 shares less 108 shares held in treasury

b.

Superior Products, Inc.

SCHEDULE COMPUTING CASH DIVIDENDS PAID TO COMMON STOCKHOLDERS AND WEIGHTED AVERAGE NUMBER OF SHARES OF COMMON STOCK OUTSTANDING

1965 Through 1969

	Shares of Common Stock		*Dividends Paid*		*Common Stock Adjusted for:*	
Dividend Date	*In Treasury*	*Out-standing*	*Per Share*	*Total*	*10% Stock Dividend*	*5 for 1 Stock Split*
6/30/65	4,000	36,000	$.40	$ 14,400	39,600	198,000
12/31/65	4,000	36,000	.48	17,280	39,600	198,000
		Total for year		$ 31,680	79,200	396,000
		Average for year			39,600	198,000
6/30/66	4,000	36,000	.11	$ 3,960	39,600	198,000
12/31/66	4,400	35,600	.11	3,916	39,160	195,800
		Total for year		$ 7,876	78,760	393,800
		Average for year			39,380	196,900
6/30/67	4,840	39,160	.10	$ 3,916	39,160	195,800
12/31/67	4,840	39,160	.30	11,748	39,160	195,800
		Total for year		$ 15,664	78,320	391,600
		Average for year			39,160	195,800
6/30/68		44,160	.40	$ 17,664		
12/31/68		44,160	.40	17,664		
		Total for year		$ 35,328		
		Average for year			42,910*	214,550
6/30/69		44,160	.60	$ 26,496		220,800
12/31/69		220,800	.40	88,320		220,800
		Total for year		$114,816		441,600
		Average for year				220,800

*The weighted average is computed as follows:

39,160 shares outstanding for 3/12 of a year =	9,790
44,160 shares outstanding for 9/12 of a year =	33,120
	42,910

c.

Superior Products, Inc.
FINANCIAL SUMMARY—1965 THROUGH 1969

	1965	*1966*	*1967*	*1968*	*1969*
1. Net income (loss)	$126,568	$(11,812)	$47,148	$115,824	$193,210
Dividends paid on preferred stock (Note A)	27,568	27,568	27,568	27,504	27,160
Earnings (loss) applicable to common stock	$ 99,000	$(39,380)	$19,580	$ 88,320	$166,050
Dividends paid on common stock	$ 31,680	$ 7,876	$15,664	$ 35,328	$114,816
2. Earnings (loss) per share of common stock (Note B)	$ .50	$ (.20)	$ .10	$ .41	$ .752
Dividends per share of common stock (Note C)	$ .16	$ .04	$ .08	$ .165	$ .52

NOTE A:
Paid semiannually at the rate of $2 per share every June 30 and December 31 to each share of 4 percent, nonparticipating $100 par value, cumulative preferred stock outstanding. Under a sinking-fund agreement, 140 shares are retired each October 1, beginning in 1968.

NOTE B:
Computed on the basis of the average number of shares outstanding each year, adjusted retroactively for a 10 percent stock dividend paid April 1, 1967 and for a 5 for 1 stock split October 1, 1969.

NOTE C:
Cash dividends paid, computed as described in Note B.

AUDITING

May 7, 1970; 8:30 a.m. to 12:00 m.

Answer 1

1. b	10. c
2. b	11. b
3. a	12. c
4. d	13. d
5. d	14. a
6. a	15. b
7. c	16. d
8. b	17. d
9. c	18. c

Answer 2

a. The objectives of a CPA's review of internal control for an opinion audit are to determine the reliability of the accounting records and from this the extent of the tests to which auditing procedures may be restricted, and to obtain evidence that the financial statements are fairly presented.

It is not possible for a CPA to verify all, or even a major portion, of the large number of transactions comprising a year's operations for most enterprises. In order that he make the most effective and searching investigation possible within practical time limits, he must determine whether the internal controls in force are sufficient to insure the integrity of the accounts. The evaluation of internal control will govern the extent of test checking and will designate those areas requiring the most intensive examination.

The CPA reviews internal control also to assist in evaluating the fairness of the financial statements. Even if the CPA examined all available audit evidence, such an examination would not be conclusive concerning the fair presentation of the financial statements because: (1) transactions may have been omitted from the records, (2) recorded transactions may have been supported by forged documents, or (3) imitation materials may have been substituted for genuine articles. Thus, the CPA relies upon the review of internal control to support the propriety of matters for which evidence is not examined as well as to enhance the reliability of evidence actually examined.

Finally, the evaluation of internal control assists the auditor in preparing his letter of recommendations to management.

b. 1. One advantage of the internal control questionnaire to a CPA is the facility with which it can be completed. If the questions have been predetermined, as is usual, the auditor's responsibility includes the completion of the questionnaire with yes-or-no answers, and written explanations are required only for the "no" or unfavorable answers. Another advantage is that better assurance of complete coverage is provided by the comprehensive list of questions. The questionnaire minimizes the possibility of overlooking important aspects of internal control.

2. An advantage to the CPA of the memorandum approach in reviewing internal control is that the memorandum is designed to explain the precise controls applicable to each examination. In this sense, the memorandum tends to be tailor-made for each engagement and thus offers flexibility in its design and application. A second advantage is that its preparation normally requires a penetrating analysis of the client's system of checks and balances. In requiring a written description of the flow of transactions, records maintained, and the division of responsibilities, the memorandum method minimizes the tendency to perform a perfunctory review.

3. The use of a flow chart in the study of internal control offers the advantage of a graphic presentation of a system or a series of sequential processes. It shows the steps required and the flow of forms or other documents from person to person in carrying out the function depicted. Thus, the tendency to overlook the controls existing between functions or departments is minimized. Another advantage is that the flow chart method avoids the detailed study of written descriptions and procedures without sacrificing the CPA's ability to appraise the effectiveness of internal controls under review. The use of a flow chart is particularly useful in the evaluation of electronic data processing systems.

c. Even though he may be satisfied that no material weaknesses in the client's internal control system exist, the CPA is required to test transactions. Testing transactions provides direct support for financial statement presentation and is also a means of determining the reliability of the system of internal control.

Control devices are fallible. Even the best of control systems cannot eliminate the possibility of unintentional irregularities resulting from temporary system breakdowns. In addition, there are certain types of actions affecting the reliability of reported data that are not subject to the enterprise control process. Examples include deliberate management irregularities, policy errors by management, and deviations arising from collusion. Through a test of transactions the CPA obtains reasonable assurance that the internal control procedures are in use and are operating as planned, and he may detect material errors of types not susceptible to effective internal control. In addition, such testing enables the CPA to comply with the third standard of field work which calls for obtaining sufficient competent evidential matter to provide a reasonable basis for an opinion.

Answer 3

a. Bell & Davis cannot be considered independent because of the material indirect financial interest of two of its partners in Worthmore, Inc. during the period of the examination of the Corporation's financial statements. This relationship constitutes a breach of independence in appearance and perhaps in fact.

Independence has been defined as an attitude of mind, much deeper than the surface display of visible standards. Neither the disposition by the wives of the partners of their financial interests in Worthmore, Inc. before the audit report was issued nor the fact that the disposition was made without gain absolves Bell & Davis of the lack of independence during its professional engagement by the client.

b. No. Bell & Davis' auditor's report is unsatisfactory since mere disclosure of the financial interest of the partners is inadequate. As a result of the firm's lack of independence, its examination was not made in accordance with generally accepted auditing standards and a disclaimer of opinion is required.

The reason for lack of independence should not be described; including the reason might confuse the reader as to the importance of the impairment of independence. Each page of the financial statements should clearly and conspicuously be marked "Unaudited—see accompanying disclaimer of opinion."

c. 1. Assuming that Worthmore, Inc. is a profit-seeking enterprise, the independence of the auditors is destroyed by the association of the two individuals who served both as members of the auditing firm and as directors for the client during the period examined. If this were permitted, the auditor would be reviewing the results of decisions in which he had participated. He would, in a sense, be auditing his own work. Consequently, he would be considered to be lacking in independence.

2. The auditor's services may consist of advice and technical services, but he must not make management decisions or take positions which might impair his objectivity. The independence of the auditing firm would be compromised by any partner making a decision on fixed asset acquisitions and the product marketing mix, but normally not by his performing a computer feasibility study.

If the former controller's participation in the feasibility study was objective and advisory, and his advice was subject to effective client review and decision, the firm's independence has not been compromised. It is desirable, however, that the former controller not participate in the audit of Worthmore's financial statements.

Moreover, while the former controller's experience may have helped him in performing the feasibility study, a person not previously associated with Worthmore perhaps could have maintained a more objective attitude; it may have been preferable to restrict the former controller's participation to that of adviser to the firm representative in charge of the feasibility study.

Answer 4

a. The auditor has the responsibility of protecting the readers of his client's annual reports from being unknowingly or intentionally misled by financial statements which are not comparable with prior years. The second standard of reporting requires the auditor's report to state whether generally accepted accounting principles have been consistently observed in the current period in relation to the preceding period. The two chief objectives of this requirement are (1) to give assurance that the comparability of financial statements as between periods has not been materially affected by changes in the accounting principles employed or in the method of their application; (2) if comparability has been materially affected by such changes, to require a statement of the nature of the changes and their effects on the financial statements.

b. 1. A change to an alternative generally accepted accounting principle which has a material effect upon financial position or results of operations requires that an exception as to consistency be made in the opinion paragraph of the auditor's report with reference made to a note to the financial statements which adequately describes the change and its effect. Alternatively, the change and its effect may be described in the auditor's report itself. Ordinarily, the disclosure should give the amount by which the current year's net income was affected as a result of the change. The reason for the change need not be stated, but the auditor may indicate his approval or disapproval of the change.

2. Changed conditions, having a material effect on the financial statements, which necessitate accounting changes but which do not involve changes in the accounting principles employed, should be disclosed in a note to the financial statements. This type of change would not ordinarily be commented upon in the auditor's report, except in some instances of filings with the Securities and Exchange Commission, since the change does not indicate inconsistencies in principles applied. As a matter of disclosure, it may be reported in a middle paragraph of the auditor's report.

3. Changed conditions unrelated to accounting would ordinarily not be reported in the auditor's report, although fair presentation may require disclosure in the notes to the financial statements. If the auditor should comment in his report upon the change, it would be a matter of disclosure and not one of consistency.

c. 1. No, the financial reporting treatment proposed by Rapid, Inc. for the 1969 annual report would not be on a consistent basis. In this case, the inconsistency arises not from a change in the application of an accounting principle in the current year, but from the lack of such application in prior years. The financial data of the prior years do not reflect the financial position and the results of operations on a pooled basis and thus are inconsistent with the financial statements of the current year.

Results of operations, balance sheets, and other historical financial data of the continuing business for periods prior to that in which the combination was effected should be restated on a combined basis.

2. The auditor's report which should be prepared to accompany the financial statements as proposed by Rapid, Inc. for inclusion in the annual report should contain a qualified or adverse opinion. The financial reporting proposed is not on a consistent basis and fails to give appropriate recognition to the pooling in the comparative statements.

   In addition, because Rapid's auditor was not the auditor of Slow Corporation at the beginning of the period, the report may require disclosures or qualifications concerning such matters as the omission of the observation of Slow's beginning inventory and the extent of responsibility to be assumed for the work of other auditors.

Answer 5

a. A general audit program for the initial audit of the stockholders' equity section of a corporation's balance sheet, excluding the audit of revenue and expense accounts, would include the following procedures:

1. Review company's internal control procedures for the stockholders' equity accounts.
2. Review pertinent regulations of state laws and of the SEC.
3. Examine nonaccounting records such as the following:
   a. Charter and charter amendments.
   b. Bylaws.
   c. Minutes of meetings of the stockholders and the board of directors from the date the corporation was organized to the date that the field work was completed.
4. Confirm with company registrar and transfer agent the amount of:
   a. Stock of each class outstanding.
   b. Treasury stock held, if any.
5. Analyze all capital stock accounts from the inception of the corporation and examine underlying evidence supporting payment or receipt for all stock repurchased and all newly issued or reissued stock.
6. Review accounting treatments of premium, discount, treasury stock and stock option plans, if any.
7. Analyze other paid-in capital accounts (donated capital, reappraisal increment, etc.) from the inception of the corporation and examine support for all transactions.
8. Review accounting treatment of stock dividends and similar capital transactions and examine evidence of market prices as appropriate.
9. Analyze retained earnings from the inception of the corporation and make appropriate cross-references to other capital accounts and the income account.
10. Verify that dividends were properly authorized and paid.
11. Examine support for other entries in the retained earnings accounts and evaluate their inclusion in retained earnings.
12. By examination of debt indentures and other pertinent documents, determine the need for and recompute any restrictions on retained earnings and ascertain other requirements and conditions relating to stockholders' equity.

b. The limitation of not confirming outstanding capital stock would not necessitate any special audit procedures since it is not a required audit procedure. The special circumstances would make advisable an extended audit of some phases:

1. Determine the extent to which reliance may be placed on the auditors who examined financial statements for the year ended December 31, 1969 and for prior years. (Based upon this review, it may be possible to utilize the other auditor's working papers.)
2. Secure a list of stockholders and number of shares held.
3. Verify all dividend payments to stockholder ownership at date of record and date of payment. (In view of the large number of stockholders a test-check basis should be used.)
4. Examine all stock bonuses paid to officers.
5. Examine all employee stock option plans and outstanding options.
6. Determine that assets, other than cash, received for stock are recorded at fair market value and that transactions were at arm's length.
7. Determine that reporting requirements of the Securities and Exchange Commission and other regulatory authorities have been met.

c. The auditor's report should disclose audited balances of the stockholders' accounts and any irregularities that were disclosed by the examination. The report must clearly indicate the limited nature of the engagement. The auditor should indicate the extent of reliance placed upon the other auditor. If he decides not to rely upon the other auditor's report, he must issue a disclaimer of opinion on the balance in the retained earnings account because he did not examine the revenue and expense accounts for the year and could not determine the fairness of the net income (or loss) for the years transferred to retained earnings.

Answer 6

a. Auditing procedures other than confirmation which may be used to verify an account receivable include:

1. Examination of evidence of subsequent payment of the account including:
   a. The customer's remittance advice accompanied by the payment. (The creditor may wish to participate in the receipt and opening of the mail.)
   b. The check sent in by the customer.
   c. An authenticated bank deposit ticket listing a deposited check for the outstanding account.
   d. An entry in the cash receipts book.
   e. A credit posted to the customer's account.
2. Examination of other evidence including:
   a. Shipping department's notice of shipment, accompanied possibly by a receipted copy of the bill of lading, the customer's purchase order, sales invoices, and any correspondence referring to the shipment of the goods.
   b. Entries removing the goods from inventory.
   c. Time records and work orders if appropriate.
3. External inquiries as to the existence and credit rating of the debtor.

4. Discussion of the account with the client's credit manager, examination of credit department records and records of merchandise returned, and such other investigation as may lead to better understanding of the nature of the account and its collectibility.

The auditor might also consider further discussion or correspondence with the debtor to determine whether alternative methods might be used to confirm the account (e.g., by furnishing the debtor more detail concerning the transaction).

b. 1. Obtaining written representations from clients has several advantages for the CPA. Obtaining representations is effective in reminding the client of his primary responsibility for the financial statements and thus is useful in securing his active cooperation. In addition, comprehensive representations are sometimes used to clarify the scope of the CPA's examination. Written representations by the client are also useful in providing the CPA with certain types of information which are not reflected in the accounts or other records. Representations may be helpful in discovering information that ordinarily could not be obtained by the use of other auditing procedures. Committing the representations of the client to writing provides evidence and is helpful in avoiding possible misunderstandings.

2. a. Only limited reliance may be placed by the CPA upon the written representations of the client, although more reliance may be placed on representations made in writing than on statements made orally. Even though written representations may be useful in disclosing information not discoverable from the books or from independent investigation, such representations complement, rather than substitute for, a proper examination, and every practicable means should be used to substantiate the information developed by the inquiries. In completing a representation letter, the client may intentionally or unknowingly misstate the representations to which he is attesting.

b. Written representations of independent experts are ordinarily worthy of reliance. These representations are useful in supplying skilled, independent opinions as to matters outside the auditor's province of technical knowledge. They should be obtained whenever reasonable diligence requires their procurement. The auditor should, of course, make appropriate investigation of the competence and reliability of the independent expert.

c. A high degree of reliance is normally associated with written representations or confirmations obtained from debtors. The reason CPAs have historically relied highly on such documentation is that these representations provide verification of the client's accounts from disinterested, independent sources. CPAs are aware, however, that debtors do not always exercise care in responding to confirmations and may confirm an item that is in fact incorrect. Accordingly, in evaluating the reliance which may be placed upon debtor representations, a CPA must consider the imperfections in debtor detection and reporting of discrepancies.

Answer 7

Aby Company
ANALYSIS OF PREPAID EXPENSES ACCOUNT
December 31, 1969

Description	Balance December 31, 1969	Adjustments and Reclassifications Debit	Adjustments and Reclassifications Credit	Prepaid Expenses Adjusted Balance December 31, 1969	Disposition: Expense Debit (Credit)	Disposition: Accounts Receivable—Other	Disposition: General Account	General Debit	General Credit
Unexpired Insurance:									
Fire	$ 750		$ 250	$ 500	$ 250				
Liability	4,900		150	4,750	150				
Utility deposits	2,000		2,000				Deposits	$2,000	
Loan to officer	500		500				Acounts receivable—loan to officer	500	
Purchase of postage meter machine, one half of invoice price	400		400				Office equipment	800	
							Accounts payable		$400
Bond discount	3,000		3,000				Unamort. bond discount	3,000	
Advertising of store opening	9,600		1,150 2,700	5,750	1,150	$2,700			
Amount due for overpayment on purchase of furniture and fixtures	675		675			675			
Unsaleable inventory—entered June 30, 1969	8,300		8,300		8,300				
Contributions from employees to employee welfare fund	(275)	$275					Due to employee welfare fund		275
Book value of obsolete machinery held for resale	550		550				Machinery held for sale	550	
Funds delivered to Skyhigh Stores with purchase offer	1,000		1,000				Deposit on contract	1,000	
	$31,400								
Prepaid postage		700		700	(700)				
		$975	$20,675	$11,700	$9,150	$3,375		$7,850	$675

Aby Company

ADJUSTING AND RECLASSIFYING ENTRIES
(Not Required)

(1)

Insurance expense			$ 400	
Prepaid expenses				$ 400
To adjust prepaid account for expired insurance:				
Fire insurance premium	$1,000			
Period covered	2 yrs.			
Expense per year ($1,000 ÷ 2)	$ 500			
Unexpired portion 12/31/69	$ 500			
Per analysis	750			
Adjustment		$ 250		
Liability insurance premium	$9,500			
Period covered	1 yr.			
Unexpired to 12/31/69	½ yr.			
Amount ½ × $9,500	$4,750			
Unexpired @ 12/31/69	$4,750			
Per analysis	4,900	150		
Adjustment		$ 400		

(2)

Accounts receivable—other			675	
Accounts receivable—loan to officer			500	
Prepaid expenses				1,175
To reclassify the overpayment of the furniture purchase to accounts receivable—other and report separately the loan to an officer.				

(3)

Accounts receivable—other			2,700	
Advertising expense			1,150	
Prepaid expenses				3,850
To adjust entry recorded erroneously and to accrue one month's expense.				
As recorded	$9,600			
Invoice amount	6,900			
Overpayment		$2,700		
Amortize 1/6 (6,900)		1,150		
Total		$3,850		

(4)

Deposits	$2,000	
Prepaid expenses		$2,000
To reclassify utility deposits as another asset.		

(5)

Office equipment	800	
Accounts payable		400
Prepaid expenses		400
To reclassify and record unpaid balance.		

(6)

Unamortized bond discount	3,000	
Prepaid expenses		3,000
To reclassify as a contra-liability.		

(7)

Loss from unsaleable merchandise	8,300	
Prepaid expenses		8,300
To charge inventory write-off to expense in year determined.		

(8)

Prepaid expenses	275	
Due to employee welfare fund		275
To reclassify funds held in trust for employees as a liability.		

(9)

Machinery held for sale	550	
Prepaid expenses		550
To reclassify machinery held for sale as another asset.		

(10)

Deposit on contract	1,000	
Prepaid expenses		1,000
To reclassify escrow deposit on purchase contract as another asset.		

(11)

Prepaid expenses	700	
Postage expense		700
To record prepaid postage in postage machine at 12/31/69 charged to expense at time of purchase.		

COMMERCIAL LAW

May 8, 1970; 8:30 a.m. to 12:00 m.

Answer 1

1. False	11. True	21. False
2. True	12. True	22. True
3. True	13. False	23. False
4. True	14. True	24. False
5. False	15. True	25. True
6. False	16. False	26. True
7. True	17. True	27. True
8. True	18. True	28. False
9. False	19. True	29. False
10. False	20. False	30. False

Answer 2

31. False	41. False	51. True
32. True	42. False	52. False
33. False	43. True	53. False
34. True	44. True	54. True
35. True	45. True	55. False
36. False	46. True	56. True
37. False	47. True	57. True
38. False	48. False	58. True
39. True	49. True	59. True
40. False	50. True	60. False

Answer 3

61. True	71. True	81. True
62. False	72. True	82. True
63. True	73. True	83. True
64. False	74. True	84. False
65. False	75. False	85. True
66. False	76. True	86. True
67. False	77. True	87. True
68. False	78. True	88. False
69. False	79. False	89. True
70. True	80. True	90. True

Answer 4

a. The first legal problem raised by the fact situation involves consideration, specifically the pre-existing legal duty rule. As the facts clearly indicate, Ajax gave no new consideration in exchange for the promise by Brown to pay an additional $12.50 per electronic testing device. Ajax was merely giving what it was already bound to give under the prior contract. According to traditional contract rules such a modification or amendment is not binding. However, the Uniform Commercial Code (2-209) has modified this rule in respect to contracts for the purchase and sale of goods. The Code provides that agreements modifying contracts for the sale of goods need no consideration to be binding. However, where the contract as modified is within the Statute of Frauds, the modification must meet the Statute's requirements. Since the modification was contained in a signed writing the Statute is satisfied and the increase is legally binding.

The second problem involves the possibility that an accord and satisfaction resulted from Ajax's cashing the check. For an accord and satisfaction to operate in a situation such as presented here, the amount must be either (or both) unliquidated or in dispute. It is obvious that the amount is liquidated, i.e., arrived at by simple arithmetic computation. Thus, this will not be a valid basis for operation of an accord and satisfaction. Was the amount in dispute? Of course, there was a dispute as to how much Brown wanted to pay or would pay. However, by dispute the law means one which has a bona fide or good faith basis for its assertion. As a result of the clarity of the Uniform Commercial Code on the point of the validity of the modification, it would seem there was no basis for a bona fide dispute. Hence, there can be no operation of an accord and satisfaction.

In conclusion, the modification was effective without consideration, the Statute of Frauds had been satisfied and there was no accord and satisfaction. Ajax is entitled to the $1,250. Under these circumstances the auditor could properly include the above item as a valid account receivable.

b. The first problem raised by the facts is the validity of the ten-day option. The question again involves consideration. Clearly the offer made by Harrison was promissory in nature. However, there was no corresponding promise or legal consideration given in exchange for this option or firm offer. According to traditional common law such promises are nothing more than offers to sell, and as such can be withdrawn any time prior to acceptance. Under this approach the offer was effectively revoked on May 5.

However, the Uniform Commercial Code (2-205) has rejected this approach. It provides: "An offer by a merchant to buy or sell goods in a signed writing which gives assurance that it will be held open is not revocable, for lack of consideration, during the time stated. . . ." Therefore, the option in question was a binding contractual obligation on Harrison's part and Franklin had until the 11th to accept.

The next problem involves the effectiveness of the acceptance, i.e., was it within the time allowed? If the acceptance were not effective until received then obviously it was too late. However, when the means of communication of the acceptance is by an authorized means, acceptance takes place at the time the acceptance is dispatched, i.e., by placing it within control of the dispatching agency. Here the use of the mail was clearly an authorized means which is defined by the Uniform Commercial Code as "any means which is reasonable under the circumstances." Hence a contract resulted on May 9th, when the letter was dispatched with the proper address and postage.

c. There are two legal problems contained in the above facts. First, was there an offer made by Fairview? Second, was it sufficiently definite and certain that upon acceptance a contract arose?

Fairview's position would undoubtedly be that it was not making an offer, but instead, was merely inviting an offer from Martin. The basis for such an assertion would undoubtedly be that it used the word "quote" in its letter of April 23rd. Mere price quotations and advertisements are normally treated as invitations to the prospective buyers to make the offer. If this be true, then the Martin Glassware Company made the initial offer in its telegram of the 24th. Since Fairview Glass rejected this offer, there was no contract.

On the other hand it seems clear that the letter of the 23rd was more than a quote. First, it was in response to a letter by Martin, dated April 20, 1970, asking for an offer. Furthermore, the letter of the 23rd contained language indicating it was for immediate acceptance. Under these circumstances it would appear that objectively there was an offer intended rather than a mere quote. The test to be used is whether or not the reasonably prudent offeree would believe the letter in question was an offer.

The chief problem in respect to definiteness and certainty involves the quantity of the different sizes of jars. How many pints, quarts, and half-gallons? From the custom of the trade we know the term "car load" means "100 gross." However, we still don't know what size jars the buyer would select. The Uniform Commercial Code (2-204) has solved this sticky problem by favoring the creation of such contracts. It provides: "Even though one or more of the terms are left open a contract for sale does not fail for indefiniteness if the parties have intended to make a contract and there is a reasonably appropriate basis for giving an appropriate remedy."

The facts of the above case would appear to be within the meaning of the Code rule.

Answer 5

a. No. Johnson's assumption of the new position represented a change in the surety's undertaking. As such, the principal debtor's (Johnson's) new duties of performance increased the surety's risk. Such a change cannot be made without the consent of the surety. The fact situation falls within the general rule that alterations of the principal contract release the surety.

b. 1. The balance sheet of Samson & Company should reflect a liability to Jackson since he may recover the balance of the Harper loan from Samson & Company. The fact that the principal debtor (Harper) has been adjudicated a bankrupt does not release the surety. This is one of the risks that the surety assumes when he agrees to act as such. The fact that Jackson joined in the petition is immaterial.

2. Samson & Company may not seek reimbursement from Harper for the amount it is obligated to pay Jackson. The discharge in bankruptcy not only discharges the balance due on the debt but any claim the surety may have to reimbursement thereon. Thus, Samson & Company may not include this claim as an asset.

c. 1. None. Except for a guaranty of collection, a surety has no right to receive notice upon default. It is the surety's duty to keep himself informed of the principal debtor's performance or default. Thus, failure to receive notice is not a defense that is available to the surety.

2. No. The creditor, in obtaining a surety, who is a primary obligor, seeks to avoid this very burden. Therefore, the surety has no right to demand that the creditor proceed against the debtor as a condition precedent to asserting liability against him.

3. A binding extension of time releases the noncompensated surety because it constitutes a material modification of the contract which affects the surety's risk. Had Hutchins agreed to the extension of time, Fredrickson would have had a valid defense.

Answer 6

a. Arthur is the drawer of the check. On a check, the drawer is the party who directs another party (the drawee) to pay the instrument to the order of a third party (the payee).

William, the person to whose order the check was payable, is the payee. Since William also transferred (negotiated) the check to another party by his endorsement and delivery of the check to Robert, he was also an endorser.

Produce Bank is the drawee of the check. The drawee is the person ordered by the drawer to pay the check to the payee or his order.

Gregory signed the check as an endorser before its delivery to William. He did so to lend his credit to William. By so doing, Gregory became an accommodation party to the check. Since he signed as an endorser, he is an accommodation endorser.

Robert acquired the check from William by William's endorsement and delivery of it to him. He thus became a holder of the check. A holder is a party in possession of an instrument which, at the time, is payable to him either as payee or endorsee or to bearer. Since Robert paid value by taking the check in satisfaction of William's debt to him, in good faith and before the check was dishonored and without knowledge of any defense thereon, he was also a holder in due course. When Robert endorsed and delivered the check to Charles, he then became an endorser.

Charles is the holder of the check. Since he paid no value for the check, he is not a holder in due course. However, since he acquired the check from Robert, who was a holder in due course, he is a holder through a holder in due course.

b. No. The defense of failure of consideration is not available against a holder in due course or a holder through a holder in due course. Here, Charles is a holder through a holder in due course (Robert) and this defense may not be asserted against him.

c. Yes. Gregory, as an accommodation endorser, is secondarily liable in the check. Accommodation endorsers are liable even though the holder knows or should know that they signed solely to accommodate another party.

d. Charles, who took the check in good faith, for value and before dishonor is a holder in due course. He may proceed against any prior endorser on the check except one who has limited or shed his secondary liability. William, by endorsing the check "without recourse" became a qualified endorser and did not warrant payment to subsequent holders. Thus, Charles may recover from Robert or Gregory, or both of them, but not from William.

As between themselves, endorsers are liable in the order in which they sign. Thus, if Charles recovers from Robert, Robert may recover over from Gregory. Robert may not, however, recover from William since, as noted above, William's qualified endorsement shielded him from liability for nonpayment.

Answer 7

a. Yes. The Bankruptcy Act enumerates certain acts which constitute acts of bankruptcy and permit the filing of an involuntary petition in bankruptcy if committed within four months of the filing. Among these enumerated acts is a transfer by a debtor, while insolvent, to a creditor, where the creditor receives a preference. A preference occurs when an antecedent debt is paid. Here, Zeta, while insolvent, paid Jones on account of an antecedent debt and thus preferred Jones. Hence, Zeta committed an act of bankruptcy. Zeta also preferred Adams.

b. Where a debtor has 12 or more unsecured creditors, at least three of them having provable claims of at least $500 must join in an involuntary petition. If there are less than 12 unsecured creditors, any one such creditor may file an involuntary petition if he has a provable claim of $500 or more. In either case the debtor's debts must aggregate at least $1,000. Here, since Zeta has 20 unsecured creditors, at least three of them who together have at least $500 in provable claims must join in any involuntary petition against Zeta.

c. The Bankruptcy Act provides that preferential liens obtained within four months preceding the filing of a petition are void as against the trustee if the creditor benefiting thereby knows or has reason to believe the debtor is insolvent and, hence, the property of the bankrupt subject to such a lien becomes available to the unsecured creditors. The Act further provides that, as of the date of the filing of the petition, the trustee acquires the status of an ideal lien creditor as to the bankrupt's assets for the benefit of the unsecured creditors.

Since Adams' lien was a preference as noted above and was obtained within the four months preceding the filing of the petition, it is void as to the trustee. Adams is thus reduced to the status of an unsecured creditor. Although Collins obtained his lien (security interest) on Zeta's machinery more than four months prior to the filing of the petition, he failed to perfect this lien prior to such filing and, hence, his rights in Zeta's machinery are subordinate to those of the trustee in the latter's status of an ideal lien creditor as of the date of filing. Barton's mortgage lien, having been obtained more than four months prior to the filing of the petition and having been duly perfected prior thereto would be good as against the trustee. If, on foreclosure of Barton's lien, a surplus is realized, such surplus would become available to pay claims of unsecured creditors. If such foreclosure produces a deficiency, Barton becomes an unsecured creditor in the amount of such deficiency.

d. Yes. The Bankruptcy Act provides that the trustee may recover any voidable preference. A voidable preference is one where a preferential payment is made within four months of the filing of a petition in bankruptcy by the debtor, while insolvent, to a creditor on account of an antecedent debt, and the creditor knows or should know that he is being preferred. Accordingly, if Jones knew of his preference when Zeta paid him the $20,000, the trustee may recover that sum from Jones.

Answer 8

a. 1. Carter was a bailee of Korn's coats; Korn was the bailor. A bailee is one who receives another's property for a specified purpose with the obligation to return it to the other. The bailor is the owner of the bailed property who delivers it to the bailee. Since both Carter and Korn stood to benefit from the bailment, it was a mutual-benefit bailment.

2. No. Ordinarily, the bailee is not liable for loss or damage to the bailed property unless he fails to exercise reasonable care. On the facts given, there is no evidence that Carter failed to exercise reasonable care.

3. No. A bailee has an insurable interest in the bailed property even though he is not the owner. Usually, the bailee is under no obligation to the bailor to insure the property.

b. 1. Devlin was a bailee for hire of Smith's and Jones' grain. As such, he is liable to Smith and Jones to deliver an equivalent quantity and grade of grain to them upon presentation of their warehouse receipts or answer in damages for his failure to do so unless such failure is not his fault. Here, Devlin sold the grain in his warehouse to Mayberry, thus rendering himself incapable of a complete delivery of grain to Smith and Jones. Devlin is thus liable to Smith and Jones for damages to the extent he is unable to deliver. Tucker holds a receipt that is invalid in its inception since it was issued without the issuer (Devlin) having received the property which it covered. Such issuance by Devlin was improper and renders him liable to Tucker for any damages Tucker may have sustained as a result thereof.

2. Smith and Jones are owners in common of the 5,000 bushels. Where a warehouseman over-issues fungible goods, the owners and holders of valid receipts are entitled to their proportionate shares of the common mass. Tucker, whose receipt, as noted above, was invalid in its inception, has no rights in the 5,000 bushels.

Neither Smith nor Jones has any rights against Mayberry since a buyer who, in the ordinary course of business, buys fungible goods from a warehouseman, who is in the business of selling such goods, takes them free of any claim under a warehouse receipt.

THEORY OF ACCOUNTS

May 8, 1970; 1:30 p.m. to 5:00 p.m.

Answer 1

1. d	11. b
2. b	12. c
3. b	13. a
4. c	14. b
5. c	15. a
6. b	16. a
7. d	17. b
8. b	18. c
9. c	19. b
10. a	20. d

Answer 2

a. Income results from economic activity in which one entity furnishes goods or services to another. To warrant revenue recognition, the earning process must be substantially complete and there must be realization—a change in assets that is capable of being objectively measured. Normally this involves an arm's-length exchange transaction with a party external to the entity. The existence and terms of the transaction may be defined by operation of law, by established trade practice or may be stipulated in a contract.

Events that give rise to revenue recognition are: the completion of a sale; the performance of a service; the progress of a long-term construction project, as in shipbuilding; and the production of a standard interchangeable good (such as a precious metal or an agricultural product) which has an immediate market, a determinable market value, and only minor costs of marketing. The passing of time may also be the event that establishes the recognition of revenues, as in the case of interest or rental revenue.

As a practical consideration, there must be a reasonable degree of certainty in measuring the amount of revenue. Problems of measurement may arise in estimating the degree of completion of a contract, the net realizable value of a receivable, or the value of a nonmonetary asset received in an exchange transaction. In some cases, while the revenue may be readily measured, it may be impossible to estimate reasonably the related expenses. In such instances revenue recognition must be deferred until the matching process can be completed.

b. Bonanza, in effect, is a merchandising firm which collects cash (for stamps) far in advance of furnishing the goods. In addition, since the data indicates that about five percent of the stamps sold will never be redeemed, it also has revenue from this source unless these stamps escheat. Bonanza's revenues from these two sources could be recognized on one of three major bases. First, all revenue could be recognized when the stamps are sold—the sales basis or cash-collection basis if all sales are for cash. Secondly, amounts collected at the time stamps are sold could be treated as an advance (sometimes referred to as deferred or unearned revenue) until stamps are exchanged for the merchandise premiums at which time all of the revenue including that relating to the never-to-be-redeemed stamps could be recognized. Thirdly, some revenue could be recognized at the time the stamps are sold and the balance could be recognized at the time of redemption—this treatment would be especially appropriate for approximately five percent of the total, the stamps that will never be redeemed. A modification of this basis would be to recognize the revenue from the never-to-be-redeemed stamps on a passage-of-time basis.

The principal expense, merchandise premium costs, should be matched with the revenue. If all revenue is recognized when stamps are sold, an accrual of the cost of the future premium redemptions would be necessary. In such a case, when stamp redemptions and related premium issuances occurred, the costs of the premiums would be charged to the accrued liability account. On the other hand, if stamp sales were treated as an advance, the deferred revenue would be recognized and the matching cost of the premiums issued would be recognized with the revenue at the time of redemption.

Under the third alternative, some predetermined portion, at least, of the revenue from the never-to-be-redeemed stamps would be recognized when the stamps are sold, but the recognition of the merchandise premium expense would be deferred until time of redemption.

Reasonable estimation is crucial to income determination. Under the first alternative it is necessary to estimate future costs of premium issuances well in advance of the actual occurrence. In the second case it is necessary to estimate the proportion of revenue which has already been earned on the basis of premium costs already incurred. It is a virtual certainty that not all stamps sold will ultimately be presented for redemption. Such factors as the number of stamps required to fill a book, the types of customers who receive stamps, and the ease of exchanging stamp books for premiums will all affect the proportion of stamps actually redeemed in relation to the potential redemptions. The difference between the five percent initial estimate and the actual proportion of unredeemed stamps affects the accrual of a liability for redemption of stamps issued under the first method and the rate of transfer of revenue from the advances account under the second and third methods.

There will be other expenses aside from the costs of premiums issued but they should be relatively small after the initial promotion period and they should be accounted for under the usual principles which apply to accrual-basis accounting. Thus, premium catalogs printed but undistributed would ordinarily be treated as prepaid expenses; wages and salaries would be treated as expenses when incurred; depreciation, taxes, and similar expenses would be recognized in the usual manner.

c. Under all of the alternatives Bonanza's major asset (in terms of data given in the question) would be its inventory of premiums. Another inventory item, perhaps minor in amount, would be the cost of printing the stamps that were on hand awaiting sale to dealers. The major account with a credit balance would be either an estimated liability for cost of redeeming the outstanding stamps under the first alternative or an advance (deferred revenue) account under the second and third alternatives. In view of the nature of the operation, the inventory account(s) would be included in the current asset classification and the liability would be classified as current. The advances could be reported preferably as a current liability or possibly as a deferred credit.

Answer 3

a. The concept that a security may be the equivalent of common stock has evolved to meet the reporting needs of investors in corporations that have issued certain types of convertible and other complex securities. A common stock equivalent is a security which is not, in form, a common stock but which contains provisions to enable its holder to become a common stockholder and which, because of its terms and the circumstances under which it was issued, is in substance equivalent to a common stock. The holders of these securities can expect to participate in the appreciation of the value of the common stock resulting principally from the earnings and earnings potential of the issuing corporation. This participation is essentially the same as that of a common stockholder except that the security may carry a specified dividend or interest rate yielding a return different from that received by a common stockholder. The attractiveness to investors of this type of security is often based principally upon this potential right to share in increases in the earnings potential of the issuing corporation rather than upon its fixed return or upon other senior security characteristics. In addition, the call characteristic of the stock options and warrants gives the investor potential control over a far greater number of shares per dollar of investment than if he owned the shares outright. With respect to a convertible security, any difference in yield between it and the underlying common stock and any other senior characteristics of the convertible security become secondary. The value of a common stock equivalent is derived in large part from the value of the common stock to which it is related, and changes in its value tend to reflect changes in the value of the common stock. Neither conversion or exercise nor the imminence of conversion or exercise is necessary to cause a security to be a common stock equivalent, but the existence of the option to convert is essential.

b. Senior securities are debt securities or preferred stock which is entitled to dividends before common stock. These senior securities may be either convertible or nonconvertible but if convertible will be considered common stock equivalents, and therefore not senior securities, in the computation of earnings per share data. Senior securities which are not convertible enter into the determination of earnings per share data by reducing earnings available to common stock (and common stock equivalents) by the amount of interest or dividends applicable to such senior securities. Interest on senior debt securities enters into the determination of net income, and dividends on preferred stock senior securities are deducted from net income to determine earnings available to common stock (and common stock equivalents).

c. Convertible securities are considered to be common stock equivalents if the cash yield to the holder at time of issuance is significantly below what would be a comparable rate for a similar security of the issuer without the conversion option. Because it may be difficult or impossible to ascertain such comparable rates, and in the interest of simplicity and objectivity, the Accounting Principles Board concluded in Opinion No. 15 that the following convertible securities should be considered as common stock equivalents at the time of issuance: (1) any convertible debt which has a cash yield to the investor based on its market price of less than 66⅔ percent of the then current bank prime interest rate and (2) any convertible preferred stock which has a cash yield based on its market price of less than 66⅔ percent of the then current bank prime interest rate. For any convertible security which has a decrease in its cash interest rate or cash dividend rate scheduled within the first five years after issuance, the lowest scheduled rate during such five years should be used in determining the cash yield of the security at issuance.

Convertible senior securities which are not considered to be common stock equivalents enter into the computation of primary earnings per share in the same manner, explained in part "b" above, as nonconvertible senior securities. Such convertible senior securities, however, enter into the determination of fully diluted earnings per share if shares of common stock (1) were issued during the period on conversions, exercise, etc., or (2) were contingently issuable at the close of any period presented if primary earnings per share for such period would have been reduced had such actual or contingent issuances taken place at the beginning of the period (or at the time the contingency arose if after the beginning of the period). The computation should be based upon the assumption that all such issued and issuable shares were outstanding from the beginning of the period, and, accordingly, any interest or dividends applicable to such convertible securities should not be deducted in computing earnings for the period. An exception exists, however, if this computation would produce anti-dilution because the purpose of the fully diluted earnings per share presentation is to show the maximum potential dilution of current earnings per share on a prospective basis. Consequently, computations of fully diluted earnings per share for each period should exclude those securities whose subsequent conversion, exercise, or other contingent issuance would have the effect of increasing the earnings per share amount or decreasing the loss per share amount for such period.

d. Under the treasury stock method, primary earnings per share should be determined as if outstanding options and warrants were exercised during the period and the funds obtained thereby were used to purchase common stock at the average market price for the period. For example, if a corporation has 10,000 warrants outstanding exercisable at $54 and the average market price of the common stock during the reporting period is $60, the $540,000 which would be realized from exercise of the warrants and issuance of 10,000 shares would be an amount sufficient to acquire 9,000 shares; thus 1,000 shares would be added to the outstanding common shares in computing primary earnings per share for the period. However, to avoid an incremental effect upon earnings per share, options and warrants should enter into the computation only when the average market price of the common stock exceeds the exercise price of the option or warrant.

Answer 4

a. Cash normally consists of coins and currency on hand, bank deposits, and various kinds of orders for cash such as bank checks, money orders, traveler's checks, demand bills of exchange, bank drafts, cashier's checks, and letters of credit. Balances on deposit in banks which are subject to immediate withdrawal are properly included in cash. There is some question as to whether deposits not subject to immediate withdrawal are properly included in cash or whether they should be set out separately. Savings accounts, time certificates of deposit and time deposits fall in this latter category. Unless restrictions on these kinds of deposits are such that they cannot be converted (withdrawn) within one year or the operating cycle of the entity, whichever is longer, there can be little question but that they are properly classed as current assets. At the same time, they may well be presented separately from other cash and their restrictions as to convertibility reported.

b. Valuation problems can arise where cash balances are in foreign countries or where a domestic entity holds a bill of exchange payable in foreign money. All balances expressed in foreign money must be converted into domestic dollar equivalents. While the conversion of cash items is fairly simple and is ordinarily done in terms of the exchange rate prevailing at the close of a fiscal period, a problem can arise as to a choice of rates where there are both official and free market rates which do not coincide. The latter has generally been interpreted to be the most clearly realistic and appropriate.

Valuation problems can also arise where there is cash in a domestic bank which has closed or is in receivership. In such cases, an estimate must be made or obtained from the receiver which reflects the probable amount to be realized in excess of balances covered fully by deposit insurance.

There is some potential of loss any time an entity accepts checks. However, only those entities which handle a substantial volume of checks giving rise to losses from insufficient funds or forgeries would ordinarily reflect a valuation allowance in respect to bank checks which have not yet cleared payor banks.

c. Realized or unrealized gains or losses can occur in connection with cash from the conversion of balances expressed in foreign money units into dollars. The trial balance in terms of foreign currency usually will not balance after it has been converted. To the extent that this imbalance can be said to relate to the conversion of cash, a gain or loss arises and is recognized. If the total of debits in dollars exceeds the total of credits in dollars, a gain has resulted; if the reverse is true, there has been a loss. Whether such a gain or loss is treated as realized or unrealized depends upon a number of factors. Where the trial balance is as of the end of the first fiscal period, such a gain is usually treated as unrealized and is carried forward into the succeeding period as a deferred credit. On the other hand, at the end of the first fiscal period such a loss is recognized immediately as realized. However, if at the end of the preceding fiscal period an unrealized gain was carried forward as a deferred credit (unrealized), a loss arising from conversion of the trial balance of the latest fiscal period would result in either the reduction of the deferred credit or in its complete elimination plus possibly the recognition of any excess as a current period loss. Of course, a gain from conversion in the most recent fiscal period would simply be added to the previously recognized unrealized gain. If at the close of a prior period a realized loss were recognized and a current loss arises upon conversion, the most recent loss is recognized as realized as well.

If a domestic company receives a bill of exchange payable in foreign currency units at some future date, it should record it as a receivable in terms of dollars realizable at the time it is received. When it is collected at maturity the number of dollars received as principal would not be equal to the number recorded at time of receipt unless exchange rates had remained stable. To the extent there is a variation, the resulting gain or loss is treated as a realized gain or loss.

d. 1. Realized or unrealized gains or losses in connection with cash can occur in the preparation of statements designed to reflect price-level changes. If an entity maintains a constant cash balance during a period in which prices rise (and, therefore, in which the general purchasing power of its cash declines) it sustains a loss which varies in proportion to the general price-level change. Conversely, it sustains a gain in general purchasing power when the general price level declines. One technique for the preparation of price-level adjusted statements does not distinguish losses as being realized or unrealized but does recognize gains or losses in connection with cash and other monetary items. Another less widely advocated technique for preparing price-level adjusted statements recognizes that the mere holding of cash during inflationary periods gives rise to unrealized losses. Under this technique, the unrealized loss is converted into a realized loss when the cash or some portion of it is disbursed.

2. General price-level financial statements or pertinent information extracted

from them presents useful information not available from basic historical-dollar financial statements. General price-level information may be presented *in addition to the basic historical-dollar financial statements*, but general price-level financial statements should not be presented as the basic statements. General price-level information is not considered to be required at this time for fair presentation of financial position and results of operations in conformity with generally accepted accounting principles in the United States.

The degree of inflation or deflation in an economy may become so great that conventional statements lose much of their significance and general price-level statements clearly become more meaningful. Some countries have experienced this degree of inflation in recent years. However, a determination has not been made as to the degree of inflation or deflation at which general price-level statements clearly become more meaningful.

Answer 5

a. Reasons for recording the transaction using Method 1, the financial accounting method, and recognizing the gain as shown include the following:

1. The new machine should be recorded at its cash equivalent cost. Recording the new machine at a lesser amount would understate assets and the resulting smaller depreciation charges would overstate net income over the years until the new machine becomes fully depreciated.
2. The difference between the cash equivalent cost of the new machine ($50,000) and the cash paid ($24,000) is a measure of the fair value of the old machine ($26,000) determined in a completed transaction. Because the old machine is no longer owned, its cost ($40,000) and accumulated depreciation ($30,000) should be removed from the books and gain recorded for the difference between its book value ($40,000 — $30,000 = $10,000) and its fair value ($26,000). The purchase of the new machine and disposal of the old machine are separate events and should be accounted for as such according to the objective evidence determined from the completed transaction.

b. Reasons for recording the transaction using Method 2, the income tax method, are primarily pragmatic and include the following:

1. The depreciable basis of the new machine for income tax reporting is $34,000 and the $16,000 gain cannot be recognized in the Corporation's federal income tax return. Thus, recording the new machine at $50,000 and reporting the $16,000 gain in the Corporation's financial statements would require that the Corporation also employ interperiod tax allocation in the financial statements to recognize that the tax-reduction benefit has yet to be received on the old machine.
2. The gain recorded using Method 1 in reality may be either a correction of

depreciation charges for prior years or a holding gain or a combination of both. Reporting a gain gives the impression that the Corporation had a realized gain from the transaction which suggests the receipt of a cash or near-cash asset—a transaction that has not in fact occurred here.

3. The method results in the new machine being recorded at cost—the undepreciated cost of the old machine plus the cash paid.
4. Objectively verifiable information as to current cash value may not be available for either the new or the old machine; the differences between current and book values may not be material and/or the increased accuracy may not be worth the added effort and expense of the additional accounting over the life of the new machine.

c. The transaction should be recorded in the manner illustrated in the question as Method 1, the financial accounting method, i.e., debit Machinery for $50,000 and credit Gain for $16,000. The cash purchase price of the new machine provides a better basis for measuring its cost and the gain from the old machine than the list price of the new machine. Sellers usually will sell a product for less than its list price when no trade-in is involved and may inflate the list price in order to offer an overly generous allowance for a trade-in. In such cases neither the list price nor the trade-in allowance should be used because they produce a fictitious overstatement of both the cost and the gain.

Answer 6

a. 1. The term "self-insurance" is a misnomer because the essence of insurance is to transfer the risk of loss to someone else; there is no such transfer in self-insurance. Self-insurance is more appropriately called no insurance, since the only way to insure is to buy the appropriate insurance.

Thus, no insurance is a policy of deliberately assuming the risk of certain casualty losses, a policy followed to some extent by all business enterprises. The decision to not insure may or may not be recognized in the accounting records, but the term "self-insurance" is most commonly applied to these situations.

2. An enterprise might elect to not insure when:
   a. It has a large number of relatively low-value-per-unit assets which are widely dispersed geographically.
   b. It has the financial strength to absorb any uninsured loss in any period.
   c. Insurance coverage is either unobtainable or so expensive that not insuring will result in a savings which is sufficient to justify the risk assumed. Typically, the pure insurance portion of a fire and casualty premium is no more than fifty percent of the total.

   An excellent example of a combination of both insurance and no insurance is found in the deductible feature of many fire and casualty insurance policies.

b. 1. "Reserve for self-insurance" generally is considered to be poor terminology; preferable titles, depending on how the account was established, would be "allowance for estimated casualty losses" or "retained earnings appropriated for possible casualty losses." The approach for establishing an allowance for estimated casualty losses begins with an estimate of average annual losses over a period of years. Each year this amount, a hypothetical insurance premium, is charged to expense and credited to this allowance (hereafter this will be called the accrual method).

The second approach is to maintain an appropriation of retained earnings equal to the maximum probable loss expected in any one year (hereafter this will be called the appropriation method).

2. Journal entries for the accrual method:

a. Each year prior to occurrence of a loss:

Estimated fire (or other casualty) losses	XX	
Allowance for estimated casualty losses		XX
To record the estimated total average annual loss.		

b. When a loss occurs:

Allowance for estimated casualty losses	XX	
Asset (for net loss)		XX
To record the cost amount of a specific loss.		

Journal entries for the appropriation method:

a. Initially, prior to occurrence of a loss:

Retained earnings	XX	
Retained earnings appropriated for possible casualty losses		XX
To record an appropriation of retained earnings for the maximum expected loss for any one year.		

b. When a loss occurs:

Fire (or other casualty) loss	XX	
Assets (for net loss)		XX
To record the cost amount for specific loss.		
Retained earnings appropriated for possible casualty losses	XX	
Retained earnings		XX

This entry (which may be deferred until year-end) may be necessary to maintain the appropriation at the maximum probable loss expected in any one year.

3. Under the accrual method the allowance account is classified as either a contra-asset or a liability account. Although both classifications have been criticized, the former is probably preferable because the allowance does not meet the conventional tests of a liability. Under the second approach the appropriation would be an owners' equity account and, more specifically, a part of retained earnings.

c. 1. The accrual method may be used in situations in which insurance coverage is available for losses that may vary widely from year to year and the company has elected to not insure, as in the case of fire insurance not being carried by the railroad on its freight loss or by the grocery chain on the merchandise inventories that it has at thousands of retail stores.

The appropriation method may be used as a complete substitute for the advance expensing of hypothetical insurance premiums. In addition it may be used for nonrecurring, noninsurable losses which cannot be objectively estimated.

2. Generally the accrual method has little theoretical justification, except as a part of an interim budgeting process, primarily because it involves the recognition of a casualty loss before a loss actually occurs. Other closely related arguments against this approach are that casualty losses, especially those for which insurance is not obtainable and which can be estimated reliably will be considered in capital budgeting decisions and reflected in the price of an asset (thus, it is considered double counting to also establish an allowance by charges to an expense); that classification of the allowance as either a liability or a contra asset involves expansion of the normal definitions of both of these classes; that this approach is merely smoothing income for the sake of smoothing; that in those cases where the losses recur regularly and are reliably estimable, recognition of the losses at time of occurrence will give approximately the same result with a simpler, less costly accounting approach; and that the firm that does not insure is different from the firm that does and accounting should not attempt to put them on a comparable basis.

   The appropriation method is the only one that is generally considered to have theoretical justification; it provides a means of actually disclosing within the financial statements information which is pertinent to evaluating the enterprise.

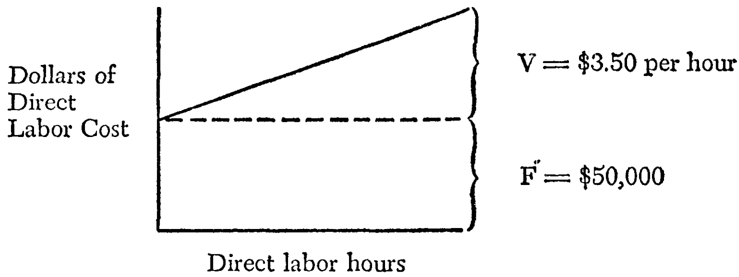
   The alternative would be no accounting recognition of a policy of no insurance until a loss occurs. Footnote disclosure, if deemed necessary, would indicate the kinds of losses for which the firm has elected to not obtain insurance.

Answer 7

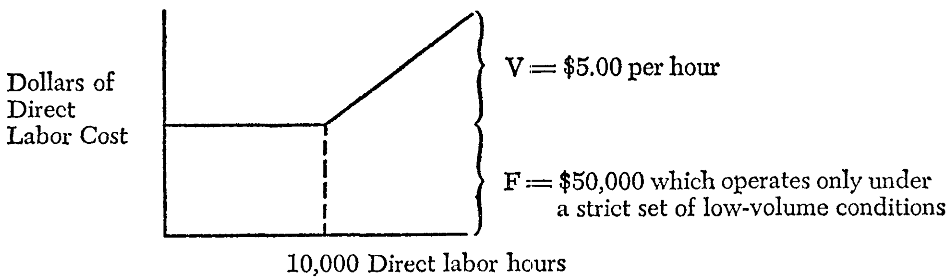
a. The variances arose because the guaranteed minimum wage was regarded as an ordinary fixed cost when, in fact, it was a special type of cost which might be called a partially fixed variable cost. This led to a budget formula for direct labor of \$50,000 per month plus \$3.50 per hour:
Fixed portion—\$600,000 ÷ 12 months = \$50,000
Variable portion—

$$\frac{\$2{,}000{,}000 - \$600{,}000}{400{,}000 \text{ hours}} = \$3.50$$

This is erroneous because the monthly cost behavior pattern assumed is:



while the correct cost pattern is:



The erroneous budget formula assumes that direct labor costs increase at a rate of $3.50 per hour rather than at the actual rate of $5.00. Moreover, there is a distinct difference between an ordinary fixed cost which does not change in total over a wide range of activity (or time) and a guaranteed cost which is fixed over some range of activity beginning at zero and ending at a level that is far less than what appears to be the relevant range in this case. The erroneous formula provides a budget allowance that is too generous when volume is less than 33,333 hours per month and too tight when volume is higher.

b. No, this budget does not reflect actual cost behavior and, thus, does not provide a basis for controlling direct labor cost. To facilitate cost control and performance evaluation, a budget must be realistic. This budget is not realistic because it reflects cost behavior at only one level of activity, 33,333 direct labor hours per month. The budget formula which should be used to reflect monthly direct labor cost for all possible activity levels is:

$50,000 + $5 (direct labor hours worked—10,000).

A simplified alternative would be to use a rate of $5.00 per hour for budgeting purposes for all volumes. In this case, no variances would appear when direct labor hours worked were 10,000 or more per month. Such a budget would apparently justify or support the production manager's belief that control was good; however, for performance evaluation he also needs an output standard to determine whether his labor inputs were used efficiently. The use of the $5.00 rate at levels at which the guarantee would be effective would help focus upon the amount of unutilized labor and would produce a variance that would measure the cost of such idle time. For example, suppose only 5,000 hours were utilized in a month:

Budget, 5,000 hours @ $5.00	$25,000
Actual, guaranteed 10,000 hours @ $5.00	50,000
Unfavorable variance	$25,000

The cost of the guaranteed minimum clause would be $25,000 for the month.

If periods of low volume could be anticipated, there could be a planned discrepancy (a budgeted variance) between the control budget and the budget used for cash planning purposes:

Budget for control purposes	$25,000
Expected variance	25,000
Budget for cash planning purposes	$50,000

c. If production in all months were expected to be at a level of 10,000 or more direct labor hours, the product cost per unit could be based simply upon a direct labor charge of $5 per hour. However, since production in some months is expected to utilize fewer than 10,000 hours, the problem arises of accounting for what can be appropriately called idle capacity costs. This is a problem for which there are conflicting solutions depending upon viewpoint and expectations. The solution advanced by an advocate of absorption costing (or an accumulator of total actual costs) would be to base the per unit product cost upon either a direct labor charge of more than $5 per hour or a direct labor charge of $5 per hour plus an overhead charge which includes the cost of expected idle time. As used here, expected refers to budgetary expectations (the budgeted direct labor cost for a period of time such as a year) which would be used as the basis for assigning labor cost to product either directly or through a combination of direct and indirect charges.

A second solution is a modification of the first, to accommodate an estimated or standard cost approach in which overhead costs and allocations are usually based upon either normal or practical capacity. If the appropriate capacity level in this case were determined to be 10,000 or more direct labor hours per month; direct labor would probably be viewed as a completely variable direct cost at $5 per hour; thus, when actual direct labor hours utilized are less than 10,000, the related idle capacity costs would appear as an unfavorable variance or a loss and would not be charged to product [e.g., if only 8,000 hours were utilized, direct labor cost of $40,000 (8,000 hours × $5) would be charged to product and $10,000 (2,000 hours × $5) would appear as either an unfavorable efficiency variance or a loss].

On the other hand, if the appropriate capacity level were determined to be less than 10,000 hours per month, different product costs could result because one of the approaches given in the first solution for accounting for expected idle time would be applicable; idle capacity costs would appear only if actual hours worked were less than the given capacity level [e.g., if the appropriate capacity level were determined to be 9,000 direct labor hours then $5,000 (1,000 hours × $5) of labor cost would appear as a part of budgeted overhead and be allocated to product, so that if 8,000 hours were utilized, $45,000 of labor costs would be charged to product ($40,000 to direct labor and $5,000 to overhead) and the idle capacity variance would be $5,000 (1,000 hours × $5)].

A third solution, and probably the preferable one in this case, is the one that would be advanced by some advocates of absorption costing and all advocates of direct costing. In this solution, per unit product costs would be based upon a direct labor charge of $5 per hour, so that any idle capacity costs would not be charged to production. The result would be the same as that suggested in the second solution where planned capacity is 10,000 hours or more per month.

Solutions and Answers to Examination November 1970

ACCOUNTING PRACTICE—PART I

November 4, 1970; 1:30 to 6:00 p.m.

Solution 1

1. d	11. c
2. d	12. b
3. d	13. a
4. d	14. a
5. a	15. b
6. d	16. a
7. b	17. c
8. b	18. c
9. b	19. d
10. a	20. b

Solution 2

a. **Lafayette Corporation**

SCHEDULE TO COMPUTE NET INCOME

For the Year Ended September 30, 1970

	Income Before Extraordinary Item	*Extraordinary Item*	*Net Income*
As tentatively reported	$400,000		$400,000
Inventory write-off	(150,000)		(150,000)
Gain on sale of subsidiary		$300,000	300,000
Adjusted income	$250,000	$300,000	$550,000

b. **Lafayette Corporation**

SCHEDULE TO COMPUTE PRIMARY EARNINGS PER SHARE AND EARNINGS PER SHARE ASSUMING FULL DILUTION

For the Year Ended September 30, 1970

	Earnings Adjusted for Assumed Conversions	*Number of Shares*	*Earnings Per Share (Income Statement)*
Primary earnings per common and common equivalent share	$540,000	360,000	$1.50
Earnings per common share assuming full dilution	$627,360*	420,000	$1.49

*Includes interest, net of tax effect, on convertible debentures for the year ended September 30, 1970:

Interest (7% × $2,400,000)	$168,000
Less income taxes (48% × $168,000)	80,640
Interest, net of tax effect	$87,360

Computation of Numbers of Shares To Be Used in Earnings Per Share Computations

Weighted average shares outstanding during year:		
October 1–November 30, 1969 (giving retroactive effect to stock split)	120,000 × 1/6	20,000
December 1, 1969–February 28, 1970	400,000 × 1/4	100,000
March 1–March 31, 1970	360,000 × 1/12	30,000
April 1–September 30, 1970	400,000 × 1/2	200,000
		350,000
Add excess of number of shares to be issued on the exercise of Series A warrants (50,000) over number of treasury shares which could be purchased with the funds obtained from the exercise of the warrants ($30 × 50,000 ÷ $37.50 = 40,000)		10,000
Number of shares to be used in primary earnings per share computation		360,000
Add shares resulting from conversion of convertible debentures (25 × 2,400)		60,000
Number of shares to be used in computation of earnings per share assuming full dilution		420,000

Solution 3

a. **James and Myra Doe**

SCHEDULE TO COMPUTE TAXABLE BUSINESS PROFIT

For the Year Ended December 31, 1969

	Income Statement (Unadjusted)	*Adjustments*	*Taxable Business Profit*
Sales (net of sales tax)	$203,800		$203,800
Gain on sale of equipment	380	$(380)	
Gain from condemnation of land (recognized gain $1,600 included in part "b"; $5,100	6,700	(1,600)	
of the gain is not taxable)		(5,100)	
Warehouse rental income	4,600	(4,600)	
	215,480		203,800
Cost of goods sold	102,110	(1,400)	100,710
Taxes—business and payroll	5,100	(857)	
		(538)	3,705
Salaries	38,080	(12,000)	26,080
Insurance	2,860	(160)	
		(180)	2,520
Advertising	1,540	(200)	1,340
Depreciation	4,700		4,700
Other deductions	16,420		16,420
	170,810		155,475
Taxable business profit	$ 44,670		$ 48,325

b. **James and Myra Doe**

SCHEDULE TO COMPUTE CAPITAL GAINS

For the Year Ended December 31, 1969

Gain on sale of condemned land (long-term)	$ 1,600
Gain on sale of investments (long-term)	31,800
Gain on settlement of Mrs. Doe's profit-sharing plan (long-term)	30,000
	63,400
Less 50% deduction	31,700
	31,700
Gain on sale of investments (short-term)	720
Capital gains	$32,420

c.

James and Myra Doe

SCHEDULE TO COMPUTE TAXABLE INCOME

For the Year Ended December 31, 1969

Wages of Mrs. Doe				$ 9,600
Dividends:				
From taxable domestic corporations			$4,310	
From foreign corporations ($1,560, net of taxes and $170 which represents the foreign tax credit on dividends received)			1,730	
			6,040	
Less dividend exclusion			200	5,840
Interest				2,236
Taxable business profit (see part "a")				48,325
Capital gains (net of 50% long-term deduction) (see part "b")				32,420
Gain on sale of equipment				380
Warehouse rental income				4,600
Medical insurance reimbursement				169
Total adjusted gross income				103,570
Medical deductions:				
Health insurance ($280÷2)			140	
Balance subject to limitation		$ 140		
Doctor and dentist bills	$2,370			
Less unpaid amount	116	2,254		
Care for Mrs. Alfred:				
Hospital	720			
Nursing home	2,400			
Housekeeper	1,300	4,420		
Medicines and drugs	970			
Less 1% of $103,570	1,036 (rounded)	–		
		6,814		
Less 3% of $103,570		3,107	3,707	
			3,847	
State income tax deduction			1,200	
Miscellaneous personal deductions			9,385	
Total personal deductions			14,432	
Personal exemptions (5)			3,000	
Total deductions and exemptions				17,432
Taxable income				$ 86,138

Solution 4

a.

Bronson Company
SCHEDULE TO COMPUTE COST VARIANCES
For the Month of September 1970

1.	Actual cost of materials purchased		$1,044,000	
	Materials purchased at standard cost			
	Miracle mix	$1,000,000		
	Drums	94,000	1,094,000	
	Materials price variance		$ 50,000	favorable
2.	Actual materials used at standard cost			
	Miracle mix	$1,300,000		
	Drums	80,000	$1,380,000	
	Standard usage (80,000×$17)		1,360,000	
	Materials usage variance		$ 20,000	unfavorable
3.	Actual direct labor cost		$ 414,100	
	Actual hours at standard cost (82,000×$5)		410,000	
	Labor rate variance		$ 4,100	unfavorable
4.	Actual hours at standard cost		$ 410,000	
	Standard hours at standard cost (80,000×$5)		400,000	
	Labor usage variance		$ 10,000	unfavorable
5.	Actual factory overhead costs		$ 768,000	
	Budgeted factory overhead costs		760,000	
	Controllable overhead variance		$ 8,000	unfavorable
6.	Budgeted factory overhead at September production level		$ 760,000	
	Factory overhead applied (80,000×$6)		480,000	
	Volume overhead variance		$ 280,000	unfavorable

b.

Bronson Company
SCHEDULE TO COMPUTE MANUFACTURING COST PER DRUM OF PRODUCT AT NEW LEVEL OF PRODUCTION

New level of production=140,000 drums	
Materials:	
Miracle mix (8×$2.10)	$16.80
Drum	1.00
	17.80
Direct labor	5.70
Fixed factory overhead	4.00
Variable factory overhead	2.50
	$30.00

Computation of Fixed and Variable Factory Overhead Cost Per Drum

	Fixed	*Variable*
Depreciation on building and machinery	$210,000	
Supervision and indirect labor	350,000*	$110,000*
Other factory overhead		90,000
	$560,000	$200,000
Fixed cost per drum at new level ($560,000 ÷ 140,000)	$ 4.00	
Variable cost per drum ($200,000 ÷ 80,000)		$ 2.50

*Computation of variable and fixed cost elements in mixed cost:

$$\text{Variable rate} = \frac{\text{change in mixed cost}}{\text{change in units}} = \frac{\$570{,}000-\$460{,}000}{160{,}000-80{,}000} = \frac{\$110{,}000}{80{,}000} = \$1.375$$

Variable cost = $1.375 × 80,000 units = $110,000
Fixed cost = $460,000 – $110,000 = $350,000

Solution 5

a. **Benjamin Industries**

SCHEDULE TO COMPUTE EFFECTS OF VARYING SALES PRICES FOR NEW PRODUCT

Sales Price	*Weighted Average Sales Level (Units)*	*Expected Monetary Sales*	*Expected Variable Costs (at $4)*	*Expected Incremental Income from Product*
$4	45,000	$180,000	$180,000	
5	43,000	215,000	172,000	$43,000
6	34,000	204,000	136,000	68,000
7	22,000	154,000	88,000	66,000

b. 1. **Benjamin Industries**

SCHEDULE TO COMPUTE CURRENT RATE OF RETURN

Current annual sales	$1,200,000
Profit rate	5%
Profit	$ 60,000
Rate of return on investment $\left[\frac{\$\ 60{,}000}{\$400{,}000}\right]$	15%

2. **Benjamin Industries**

SCHEDULE TO COMPUTE RATE OF RETURN UNDER GREEN'S SUGGESTION

Sales (2×$1,200,000)	$2,400,000
Profit rate	4%
Income	$ 96,000
Return on investment ($96,000÷$500,000)	19.2%

3. **Benjamin Industries**

SCHEDULE TO COMPUTE RATE OF RETURN UNDER GOLD'S SUGGESTION

Sales (90%×$1,200,000)	$1,080,000
Profit rate	7%
Income	$ 75,600
Return on investment ($75,600÷$600,000)	12.6%

c. **Benjamin Industries**

SCHEDULE TO COMPUTE NET PRESENT VALUES OF VARIOUS INVESTMENT OPPORTUNITIES

	Black	*White*	*Gray*
Discounted cash flows:			
Year 1	$ 8,000	$20,000	$ 8,000
Year 2	28,000	21,000	10,500
Year 3	42,000	3,000	9,000
Total cash flows	78,000	44,000	27,500
Financing requested	80,000	40,000	30,000
Net present value	$(2,000)	$ 4,000	$(2,500)

ACCOUNTING PRACTICE—PART II

November 5, 1970; 1:30 to 6:00 p.m.

Solution 1

1. e	11. b
2. e	12. a
3. d	13. a
4. c	14. b
5. e	15. e
6. e	16. a
7. d	17. b
8. b	18. d
9. d	19. e
10. d	20. b

Solution 2

a.

White Manufacturing Corporation

ADJUSTING JOURNAL ENTRIES

October 31, 1970

(Not Required)

(1)		
Deferred gross profit on installment sales	$ 22,000	
Realized gross profit on installment sales		$ 22,000
To recognize all deferred gross profit on installment sales.		
(2)		
Operating expenses	8,000	
Allowance for collection and repossession expense		8,000
To establish an allowance for estimated collection and repossession expense necessitated by a change of method of accounting for installment receivables.		
(3)		
Allowance for doubtful accounts	4,500	
Accounts receivable		4,500
To write off as uncollectible an account receivable from Wise Company.		

(4)

Operating expenses		$ 9,500	
Allowance for doubtful accounts			$ 9,500
To adjust the allowance for doubtful accounts to an estimated $11,000.			

(5)

Accrued interest receivable		300	
Revenue			300
To accrue interest on notes receivable.			

(6)

Inventories		3,000	
Ed White, Capital			1,000
Fred White, Capital			1,000
Greg White, Capital			1,000
To adjust the inventory balance to net realizable value:			
Net realizable value	$63,000		
Book value	60,000		
Adjustment	$ 3,000		

(7)

Ed White, Capital		2,700	
Fred White, Capital		2,700	
Greg White, Capital		2,700	
Marketable securities			8,100
To adjust the marketable securities account to net current value:			
Book value	$30,000		
Current value	21,900		
Adjustment	$ 8,100		

(8)

Allowance for depreciation – plant, property and equipment		70,000	
Plant, property and equipment			43,000
Ed White, Capital			9,000
Fred White, Capital			9,000
Greg White, Capital			9,000
To adjust plant, property and equipment to current value:			
Cost basis	$190,000		
Less accumulated depreciation	70,000		
Book value	120,000		
Current value	147,000		
Adjustment	$ 27,000		

White Manufacturing Corporation

WORKSHEET TO DETERMINE OPENING ACCOUNT BALANCES

October 31, 1970

	White Brothers Manufacturing Company *Trial Balance*		*Adjusting Entries*		*White Manufacturing Corporation* *Beginning Balances*	
	Debit	*Credit*	*Debit*	*Credit*	*Debit*	*Credit*
Cash	$ 50,000		$(10) 120,000	$(11) 31,700	$138,300	
Notes receivable	10,000				10,000	
Installment contracts receivable	58,000				58,000	
Accounts receivable	80,000			(3) 4,500	75,500	
Allowance for doubtful accounts		$ 6,000	(3) 4,500	(4) 9,500		$ 11,000
Inventories	60,000		(6) 3,000		63,000	
Marketable securities	30,000			(7) 8,100	21,900	
Plant, property and equipment	190,000			(8) 43,000	147,000	
Allowance for depreciation–plant, property and equipment		70,000	(8) 70,000			
Accounts payable		105,000				105,000
Deferred gross profit on installment sales		22,000	(1) 22,000			
Ed White, Capital		62,000	(7) 2,700	(6) 1,000		
			(12) 110,900	(8) 9,000		
				(9) 41,600		
Ed White, Drawing	15,000		(11) 5,900	(12) 20,900		

	White Brothers Manufacturing Company Trial Balance		Adjusting Entries		White Manufacturing Corporation Beginning Balance	
	Debit	Credit	Debit	Credit	Debit	Credit
Fred White, Capital		70,000	(7) 2,700	(6) 1,000		
			(12) 118,900	(8) 9,000		
				(9) 41,600		
Fred White, Drawing	16,000		(11) 12,900	(12) 28,900		
Greg White, Capital		72,000	(7) 2,700	(6) 1,000		
			(12) 120,900	(8) 9,000		
				(9) 41,600		
Greg White, Drawing	18,000		(11) 12,900	(12) 30,900		
Revenue		870,000	(9) 870,300	(5) 300		
Cost of sales	500,000			(9) 500,000		
Operating expenses	250,000		(2) 8,000	(9) 267,500		
			(4) 9,500			
	$1,277,000	$1,277,000				
Realized gross profit on installment sales			(9) 22,000	(1) 22,000		
Allowance for collection and repossession expense				(2) 8,000		8,000
Accrued interest receivable			(5) 300		300	
Common stock				(10) 100,000		
				(12) 300,000		400,000
Premium on common stock				(10) 20,000		
				(12) 60,000		80,000
Goodwill			(12) 90,000		90,000	
			$ 1,610,100	$ 1,610,100	$604,000	$604,000

(9)

Revenue	$870,300	
Realized gross profit on installment sales	22,000	
Operating expenses		$267,500
Cost of sales		500,000
Ed White, Capital		41,600
Fred White, Capital		41,600
Greg White, Capital		41,600
To close all revenue and expense accounts to the capital accounts.		

(10)

Cash	120,000	
Common stock		100,000
Premium on common stock		20,000
To record the sale of 10,000 shares of common stock at $12.		

(11)

Ed White, Drawing	5,900	
Fred White, Drawing	12,900	
Greg White, Drawing	12,900	
Cash		31,700
To record a distribution of cash to the partners.		

(12)

Ed White, Capital	110,900	
Fred White, Capital	118,900	
Greg White, Capital	120,900	
Goodwill	90,000	
Ed White, Drawing		20,900
Fred White, Drawing		28,900
Greg White, Drawing		30,900
Common stock		300,000
Premium on common stock		60,000
To record the exchange of each partner's interest for 10,000 shares of common stock and to record goodwill.		

b. **White Manufacturing Corporation**

SCHEDULE TO COMPUTE GOODWILL

October 31, 1970

	Ed White	*Fred White*	*Greg White*	*Total*
Partners' capital balances from trial balance October 31, 1970 before adjustments	$ 62,000	$ 70,000	$ 72,000	$204,000
Worksheet adjustments:				
Inventory adjustment	1,000	1,000	1,000	3,000
Marketable securities adjustment	(2,700)	(2,700)	(2,700)	(8,100)
Plant, property and equipment adjustment	9,000	9,000	9,000	27,000
Adjusted capital balances	69,300	77,300	79,300	225,900
Add net income	41,600	41,600	41,600	124,800
	110,900	118,900	120,900	350,700
Less drawings (including October 31, 1970 distribution)	20,900	28,900	30,900	80,700
Partners' final balances	$ 90,000	$ 90,000	$ 90,000	$270,000
Stock distribution (10,000 shares to each partner at a market value of $12 per share)	$120,000	$120,000	$120,000	$360,000
Less partners' final balances	90,000	90,000	90,000	270,000
Goodwill	$ 30,000	$ 30,000	$ 30,000	$ 90,000

Solution 3

a. **Mountainview Corporation**

ADJUSTING JOURNAL ENTRIES

September 30, 1970

(1)

Receivables from officers	$ 8,500	
Advances to employees	1,411	
Accounts receivable		$ 8,165
Customer advances		1,746

To reclassify nontrade accounts receivable and credit balances in customer accounts.

(2)

Allowance for doubtful accounts	$ 1,187	
Accounts receivable		$ 1,187
To write off uncollectible accounts.		

(3)

Doubtful accounts expense	78,750	
Allowance for doubtful accounts		78,750
To record estimated doubtful accounts expense of ½% of the year's net credit sales of $15,750,000.		

b. **Mountainview Corporation**

SCHEDULE TO COMPUTE MIDDLE STRATUM OF ACCOUNTS RECEIVABLE

September 30, 1970

Correct total of 8 accounts showing errors	$ 6,670
Total of 42 accounts with no errors	37,280
Correct total of 50 accounts in sample	$ 43,950
Average ($43,950 ÷ 50)	$ 879
Estimate of 625 accounts ($879 × 625)	$549,375

c. **Mountainview Corporation**

SCHEDULE TO COMPUTE ESTIMATED TOTAL ACCOUNTS RECEIVABLE

September 30, 1970

First stratum:			
Total per subsidiary ledger		$120,004	
Less overstatement		970	
Correct total of first stratum			$119,034
Second stratum:			
Estimate of 625 accounts			600,000
Third stratum:			
Total accounts receivable according to subsidiary ledger		768,594	
Less: First stratum	$120,004		
Second stratum	559,875		
Net adjustments in part "a"	10,000	689,879	
Total of third stratum per subsidiary ledger		78,715	
Less overstatement		4,570	
Correct total of third stratum			74,145
Estimated total accounts receivable			$793,179

Solution 4

a. **DeMars College**

SCHEDULE TO COMPUTE THE EXPECTED ENROLLMENT, CREDIT HOURS AND FACULTY MEMBERS

Academic Year 1971-72

		Credit Hours			
	Enrollment	*Average*	*Total*	*Per Faculty Member*	*Total Faculty Needed*
Lower division	2,750*	33	90,750	750**	121
Upper division	1,700	30	51,000	600***	85

*110% × 2,500
**25 × 30
***20 × 30

b. **DeMars College**

SCHEDULE TO COMPUTE FACULTY SALARIES BUDGET

Academic Year 1971-72

	Faculty Needed	*Average Salary*	*Total Base Salaries*	*Merit Increases*	*Total Faculty Salaries*
Lower division	121	$10,500	$1,270,500	$ 90,750	$1,361,250
Upper division	85	10,500	892,500	85,000	977,500
			$2,163,000	$175,750	$2,338,750

c. **DeMars College**

SCHEDULE TO COMPUTE TUITION REVENUE BUDGET

Academic Year 1971-72

	Tuition-Paying Students	*Average Credit Hours Per Student*	*Total Student Credit Hours*	*Tuition Per Credit Hour*	*Total Tuition Budget*
Lower division	2,725*	33	89,925	$22	$1,978,350
Upper division	1,685**	30	50,550	22	1,112,100
			140,475		$3,090,450

*2,750–25 scholarships
**1,700–15 scholarships

d. **DeMars College**

SCHEDULE TO COMPUTE THE AMOUNT TO BE RAISED DURING ANNUAL SUPPORT CAMPAIGN

Academic Year 1971-72

Budgeted expenditures:		
Faculty salaries		$2,400,000
Operation and maintenance of plant equipment:		
Salaries and wages ($90,000 $\times$ 105%)	$ 94,500	
Other ($120,000 + $9,000)	129,000	223,500
Administrative and general		240,000
Library		160,000
Health and recreation		75,000
Athletics		120,000
Insurance and retirement		265,000
Interest		48,000
Capital outlay		300,000
		3,831,500
Budgeted revenues:		
Tuition	3,000,000	
Endowments	114,000	
Auxiliary services	235,000	
Athletics	180,000	3,529,000
Amount to be raised during annual support campaign		$ 302,500

Solution 5

21. d	31. a
22. d	32. b
23. c	33. c
24. d	34. b
25. b	35. d
26. a	36. a
27. c	37. a
28. b	38. b
29. a	39. c
30. d	40. b

Solution 6

a. 1. **Downtemp Company**

SCHEDULE TO COMPUTE COST OF GOODS SOLD ON INSTALLMENTS

For 1967, 1968 and 1969

	1967	*1968*	*1969*
Purchases:			
1,200 units @ $100	$120,000		
1,800 units @ $90		$162,000	
800 units @ $105			$ 84,000
Repossessed 40 units @ $63			2,520*
Inventory at December 31:			
1967 (1,200−1,000=200×$100)	(20,000)	20,000	
1969 (840−740=100×$103)			(10,300)
Cost of goods sold	$100,000	$182,000	$ 76,220

2. **Downtemp Company**

SCHEDULE TO COMPUTE AVERAGE UNIT COST OF GOODS SOLD ON INSTALLMENTS

For 1967, 1968 and 1969

1967 ($120,000÷1,200)	$100
1968 ($182,000÷2,000)	$ 91
1969 ($ 86,520÷840)	$103

*An alternative valuation of the repossessed merchandise would be at an amount to earn the normal gross profit for the period.

b. **Downtemp Company**

SCHEDULE TO COMPUTE GROSS PROFIT PERCENTAGES

For 1967, 1968 and 1969

	1967	*1968*	*1969*
Sales:			
1,000 units @ $150	$150,000		
2,000 units @ $140		$280,000	
700 units @ $143			$100,100
40 units @ $72.50			2,900
	150,000	280,000	103,000
Cost of sales	100,000	182,000	76,220
Gross profit	$ 50,000	$ 98,000	$ 26,780
Gross profit percentages:			
$50,000 ÷ $150,000	33⅓ %		
$98,000 ÷ $280,000		35%	
$26,780 ÷ $103,000			26%

c. **Downtemp Company**

SCHEDULE TO COMPUTE LOSS ON REPOSSESSIONS

For 1969

Original sales amount (40 × $140)		$5,600
Collections prior to repossessions		1,200
Unpaid balance		4,400
Deduct:		
Unrealized gross profit ($4,400 × 35%)	$1,540	
Value of repossessed merchandise	2,520	4,060
Loss on repossessions		$ (340)

d. **Downtemp Company**

SCHEDULE TO COMPUTE TAXABLE INCOME FROM INSTALLMENT SALES

For 1969

Installment sales	$103,000
Cost of goods sold	76,220
Gross profit	26,780
Less gross profit to be deferred on 1969 installment sales ($103,000 − $21,000 = $82,000 × 26%)	21,320
Gross profit realized on installment sales:	
1969 ($21,000 × 26%)	5,460
1968 ($115,000 × 35%)	40,250
1967 ($60,000 × 33⅓%)	20,000
	65,710
Loss on repossessions	340
Net gross profit realized	65,370
General and administrative expense	51,000
Net income	$ 14,370

AUDITING

November 5, 1970; 8:30 a.m. to 12:00 m.

Answer 1

1.	d.	11.	b.
2.	a.	12.	b.
3.	c.	13.	d.
4.	b.	14.	a.
5.	d.	15.	b.
6.	c.	16.	a.
7.	d.	17.	c.
8.	c.	18.	b.
9.	a.	19.	c.
10.	d.	20.	c.

Answer 2

21.	a.	31.	a.
22.	b.	32.	d.
23.	d.	33.	a.
24.	d.	34.	c.
25.	a.	35.	a.
26.	d.	36.	a.
27.	c.	37.	d.
28.	b.	38.	b.
29.	d.	39.	a.
30.	b.	40.	c.

Answer 3

Case 1

a. 1. If a CPA did not prepare the tax return he generally has no obligation to sign the preparer's declaration. He may sign the declaration on a return prepared by the taxpayer or another if, in the course of his review, he acquires knowledge substantially equivalent to that which he would have acquired had he been the preparer. If the CPA reviews a return prepared by the taxpayer or another and (under authority conferred by the taxpayer) either makes substantial changes in the return or directs that such changes be made, he is considered to be a preparer. As such he should satisfy himself as to the content of the entire return and sign the preparer's declaration.

2. Review procedures will vary from one return to another. The extent of the review will be determined by the professional judgment of the CPA. If the client's controller is a recognized expert in the field of taxation, the review procedures of the CPA prior to his signing the client's tax return will probably be limited. Regardless of the expertise of the client's controller, any time the return is complex it should be reviewed more extensively because of the CPA's responsibility to acquire the same degree of knowledge that he would have had if he had actually prepared the return. If the CPA signs the preparer's declaration, he assumes the responsibilities of the actual preparer.

Case 2

1. If the client insists upon unacceptable changes in the initially prepared tax return, the CPA should neither prepare the revised return nor sign the preparer's declaration on the revised form. Only if the client modifies his request to the point that the changes are acceptable to the CPA may the latter prepare the return and sign the preparer's declaration.
2. The preparer's declaration states that the return is true, correct and complete to the best of the preparer's knowledge. Doubtful items may be resolved in favor of the client when there is reasonable support for the client's position. In this case the CPA obviously believes that there is not reasonable support.

Case 3

1. A CPA should sign as preparer any federal tax return which requires such a signature, whether or not he prepared the return for compensation. (Federal Income Tax Regulations require the preparer's signature only if the return was prepared for compensation. The AICPA Statement on Responsibilities in Tax Practice No. 1, "Signature of Preparer," goes beyond the scope of this Regulation, requiring the preparer's signature whether or not the return was prepared for compensation.)
2. In this instance, the CPA prepared the return for his brother-in-law and should sign the preparer's declaration to comply with the stricter professional requirements. The act of preparing the return and not the fact of reimbursement establishes the CPA's responsibility to sign the return.

b. 1. A CPA may prepare tax returns involving the use of estimates if such use is generally acceptable or if it is impracticable to obtain exact data. Approximations based on judgment are generally accepted for many accounting measurements. Examples include the estimates of useful life and salvage value for depreciation, provisions for doubtful accounts and allocations of overhead. Estimates are also justified (1) in cases of minor expenditures or (2) when all the facts pertaining to a transaction have not been or cannot be ascertained.

2. When a CPA uses estimates in a client's tax return he assumes the responsibility for avoiding deception and misleading impressions. Estimates should not be presented in such a way as to imply greater accuracy than actually exists. The CPA must be satisfied that the estimate is reasonable under the circumstances.

   If the use of accounting judgments is accepted and expected in a particular case, no disclosure need be made. In addition, use of estimates for accruals of income and expense (if other conditions for accrual are met) and for small expenditures is accepted without disclosure.

   Under some circumstances use of a rounded amount or an amount suggested in a Treasury Department guideline in itself may constitute adequate disclosure that an estimate has been used. In other instances it may be necessary for the CPA to state expressly that an amount has been estimated. If a tax return entry is an aggregation of items which includes a significant estimated amount, the estimated amount should be disclosed.

Answer 4

a. Assuming that Frank George & Co. was able to perform alternative auditing procedures to satisfactorily substantiate the buyers' cash working fund and purchases through the fund, the deficiencies in the auditor's report include the following:

1. The report should not be addressed to an officer of the client but instead to the Sunshine Manufacturing Co. itself, its board of directors or its shareholders.
2. The scope paragraph of the report should indicate that the examination was made in accordance with generally accepted auditing standards. These standards pertain to the auditor's professional qualities and judgment and are applicable in every examination and report with which he is involved.
3. The balance sheet presents financial data as of a specific date. The scope paragraph of this report erroneously describes it as a period statement. The first line of the report should read: "We have examined the

balance sheet of the Sunshine Manufacturing Co. as of August 31, 1970 and the related statements of income and retained earnings for the year then ended."

4. The references to the financial statements are inconsistent. The scope paragraph refers to a statement of retained earnings and the opinion paragraph to a statement of earned surplus. The exact title of the statement should be included in the report, and one of these references obviously is wrong. The term "retained earnings" normally is preferred to "earned surplus."
5. No reference to the scope limitation or the use of alternative procedures is required in the auditor's report. There is, in effect, no limitation on the scope of the examination because alternative auditing procedures are satisfactory. The auditor may describe the circumstances in the middle paragraph of his report if he wishes, but to do so may mislead readers of the report as to the meaning of the disclosure.
6. No qualification of the opinion is necessary as the auditor has satisfied himself by alternative procedures as to the proper presentation of financial position and the results of operation.
7. The report does not state whether the financial statements are presented in conformity with generally accepted accounting principles. Such a statement is required by the first standard of reporting unless the auditor is issuing a disclaimer of opinion. In this case, as the auditor satisfied himself by alternative procedures, he can render an unqualified opinion as to conformity with generally accepted accounting principles.
8. No opinion has been expressed as to the consistency of the financial statements with the prior year. This would be correct only if the Company were newly formed. As the Company was in operation in prior years, the auditor has a responsibility to determine that the accounting principles applied were consistent with the preceding year. If he is unable to do this, or if he finds that the client has not applied generally accepted accounting principles on a basis consistent with that of the preceding year, he must qualify his report accordingly.
9. The date affixed to the report should be that of the completion of all important audit procedures, usually the last day of work in the client's office. In this case, the auditor's report has been dated August 31, 1970, the date of the balance sheet. It is extremely unlikely that all audit procedures could have been completed at that time.

b. Assuming that Frank George & Co. was unable to satisfactorily substantiate the buyers' cash working fund and purchases through the fund by alternative auditing procedures, the proposed wording of the opinion qualification is incorrect in two respects:

1. The use of the "subject to" qualification is restricted to uncertainties

which cannot be clarifed by the extension of auditing procedures. A limitation on audit scope leads to an "except for" qualification or, if sufficiently material, a disclaimer of opinion.

2. The qualification should not refer to the restriction on procedures employed but rather to items on which an opinion cannot be expressed or to which the auditor is taking exception. The auditor should take exception to the presentation of the buyers' cash working fund and purchases through the fund.

c. The CPA as a professional man must rely primarily upon himself for control of the quality of examinations and reports. He must recognize his responsibilities to the profession, to licensing and regulatory bodies, to his clients and to others relying upon his reports.

The CPA's certificate may be suspended or revoked by the state which issued it. In addition, the CPA may be held to be in violation of the codes of ethics of professional accounting associations to which he belongs. Disciplinary action also may be taken, where appropriate, by governmental agencies such as the Securities and Exchange Commission.

Inasmuch as they operate as sole practitioners, in partnerships or in professional corporations CPAs have unlimited legal liability to the extent of their personal worths for damages caused to others by substandard examinations or reports. Their contractual responsibility to clients historically has been considered more exacting than that to third-party users of the report, except when the CPA knows the report is to be used for a particular purpose. It must be recognized, however, that malpractice suits are increasing and that courts are extending liability to third parties with increasing frequency. (Liability to third parties for opinions included in filings with the Securities and Exchange Commission was previously extended by statute.) In addition, practitioners (staff accountants as well as partners and supervisors) may be held criminally as well as civilly liable.

The CPA should never assume that his reports will be used only for those purposes or by those persons for whom they were initially intended. He must emphasize fair presentation as well as conformity to generally accepted accounting principles. He must be sure that both the auditing standards upon which he bases his examination and the auditing procedures he employs are adequate in terms of the circumstances of the particular engagement. In the future a court review may be made by a judge and jury who are not professional accountants, and they may apply standards not in effect at the time of the examination.

Answer 5

a. Major objectives of the audit of Manufacturing Equipment, Manufacturing Equipment–Accumulated Depreciation, and Repairs to Manufacturing Equipment are to determine that:

1. The Manufacturing Equipment account represents the cost of manufacturing equipment in use at December 31, 1969.
2. The Company owns the property and to ascertain the nature of any liens or other obligations against the property.
3. The property is in existence, adequately insured, and recoverable through service potential or liquidation.
4. Additions for the year have been accurately recorded and there has been a proper differentiation between capital and maintenance charges.
5. Retirements of property during the year, together with the associated salvage and cost of removal, have been properly recognized.
6. A proper amount of depreciation expense has been allocated to the period. based on the asset cost, estimated life, and salvage.
7. Accumulated depreciation is adequate but not excessive.
8. Repairs represent an expense of the current period and necessary maintenance has not been deferred to later periods.

b. Auditing procedures for 1969 additions to Manufacturing Equipment include the following:

1. Obtain a list of cash disbursements charged to Manufacturing Equipment and cross-reference to the analysis of the Manufacturing Equipment account. (Limits may be used in making this list.)
2. Review the list for reasonableness and the propriety of the account charged.
3. For major disbursements and a sample of other disbursements, perform the following steps:
   a. Examine supporting documentation.
   b. Determine that required budgetary approvals and explanations of variances from the budget have been made.
   c. For equipment requiring installation, determine that a capital work order for the installation was established.
   d. For equipment replacements, determine that the appropriate retirement has been made.
   e. Trace property additions into the subsidiary ledger.
4. Obtain a list of construction work orders in process and completed during the year. The list should show a description of the work done, the account charged, and the budgeted and actual expenditures. (Limits may be used in making this list.)
   a. Cross-reference the list to the analysis of Manufacturing Equipment.
   b. Review the list for reasonableness of expenditure and the propriety of the account charged. Investigate abnormalities.
5. Examine construction work orders in detail on a test basis:
   a. Cross reference charges to the list of work orders and trace the amount of property additions into the subsidiary ledger.
   b. Trace time and material charges to supporting payroll and material

usage records. (The extent of this check will depend on what work has been done on the detail tests of payroll and material.) Review the reasonableness of the hours worked, the work description and the material used in terms of the work order description.

c. Evaluate the policy and procedures for allocating overhead to the work order and check their application.

d. Examine support for and evaluate propriety of other charges to the work order.

e. Determine that proper budgetary approval has been given. Compare budgeted amounts with actual expenditures and ascertain that required explanations for variances have been made.

f. Determine that corresponding retirements of manufacturing equipment have been made and properly accounted for.

6. Review the propriety of other charges to Manufacturing Equipment and check to supporting documentation (on a test basis, if appropriate).
7. Physically inspect any major additions for the year and a random sample of other additions.
8. Discuss plant operations with responsible operating personnel. Inquire about capitalization policies, obsolete or unused machinery, major additions and retirements in 1969 and any questions arising during the examination.

Answer 6

a. 1. As a result of the change in accounting for depreciation, Noches' financial statements for 1969 are not presented on a basis consistent with the prior year. If the 1968 method had been used, the depreciation provision for 1969 and accumulated depreciation at December 31, 1969, would have been $200,000 greater and income for 1969 and retained earnings at December 31, 1969 would have been $200,000 less. (If interperiod tax allocation had been properly applied, the consistency effect would have been $104,000.)

Failure to use interperiod income tax allocation results in the statements not being presented in accordance with generally accepted accounting principles. Reported 1969 federal income tax expense and the liability for deferred federal income taxes are understated by $96,000, and 1969 income and retained earnings are overstated by $96,000.

The change in accounting method has no effect on funds provided by operations because depreciation expense does not require the current use of funds and the amount of federal income taxes currently payable is unchanged. The use or nonuse of interperiod tax allocation methods has no effect on the amount of funds provided but may affect the presentation in the funds statement.

2. In order for the 1969 financial statements of Noches, Inc. to be adequately informative there must be disclosure of the change in accounting for depreciation and the related effect upon net income for the year. There must also be disclosure of the Corporation's failure to use interperiod income tax allocation. These disclosures may be made in the notes to the financial statements.

   The footnote disclosing the change in depreciation methods should be keyed to the accumulated depreciation account in the balance sheet and to the reported depreciation expense and net income on the income statement. The footnote disclosing the failure to allocate income taxes should be keyed to the reported tax expense and net income in the income statement and to the tax liability reported on the balance sheet.

b. 1. Both the present and prior methods of accounting for depreciation are generally accepted, but a qualification of the auditor's opinion as to consistency of application of accounting principles is necessary. The auditor's report may refer to the appropriate footnote(s) to the financial statements for description of the change.

2. If informative disclosures in the financial statements are not reasonably adequate, generally accepted auditing standards require the auditor to disclose in his report matters which have not been properly disclosed in the financial statements and to appropriately qualify his opinion.
3. If his client changes the method of accounting from one generally accepted method to another generally accepted method, the auditor, if he wishes, may indicate his approval of the change. This treatment is not mandatory, however, since absence of qualification indicates acceptance. As Noches has not adopted interperiod tax allocation, the auditor might decide that it would be unnecessarily confusing to readers for him to indicate approval of the change in depreciation methods.
4. The opinion should be qualified as to conformity with generally accepted accounting principles because of the failure to use interperiod tax allocation. The effects on financial position, if considered material, and the effects on the results of operations should be referred to or shown in the report. If the effects are considered so material that the auditor feels the financial statements do not fairly present the financial position and the results of operations, he should render an adverse opinion.

Answer 7

Note 1

a. Objectives

1. To improve the reliability and accuracy of accounting data related to livestock purchases and receipts and thereby promote operational efficiency.

2. To safeguard Company assets by establishing that livestock purchased are actually received.
3. To safeguard Company assets and encourage adherence to prescribed managerial policies by separating the purchasing, receiving and accounting functions.

b. Weaknesses and Suggestions

The purchasing and receiving functions have not been properly separated, and proper reporting has not been established. Returning the completed receiving report to the buyer enables him to retain control over the receiving function. Properly, he and the receiving authority should make independent reports to the accounting department. Each report should include the vendor's name and the number of head and total weight in the shipment. Price and other terms of the purchase should be included in the buyer's report.

The buyer may furnish a copy of his report to the plant for use as a receiving report. This should be a "blind" copy, i.e., it should omit the number of head and weights for the incoming shipment; these should be inserted independently.

Responsibility for receiving has not been clearly assigned and the person receiving cannot be identified. Specific employees should be charged with this responsibility, and the receiving report should be initialled or signed. Provision should be made for providing a check on the weights of the livestock received. Better inspection of the condition of incoming shipments and reporting of this inspection also are necessary.

Present procedures do not call for a check on delinquent deliveries. The buyer is not notified until all shipments are received. The buyer or another person should be assigned responsibility for expediting delivery, and a procedure should be instituted to provide this person with timely data on the status of incoming shipments.

Note 2

a. Objectives

1. To safeguard Company assets by ensuring that payments are made only for valid liabilities representing merchandise purchased and received.
2. To safeguard Company assets and encourage adherence to prescribed managerial policies by separating the accounting and disbursing functions from each other and from the purchasing and receiving functions.

b. Weaknesses and Suggestions

The buyers have too much control over the purchasing-disbursement cycle and are performing both accounting and treasury functions. The buyers should neither receive nor approve the vendors' invoices; review of the invoice, including matching with the buyer's report, receiving report, and bill of lading should be performed in the accounting department. Checks should not be delivered to buyers but should be sent directly to the vendor by the treasurer's office.

The treasurer or his delegate should review the disbursement voucher, as well as the check, in order that he may better verify that the disbursement is proper. The treasurer's department should cancel approved disbursement vouchers and supporting documents to prevent their use in support of another disbursement.

Note 3

a. Objective

To safeguard Company assets and promote operational efficiency by establishing control over livestock in process and completed carcasses.

b. Weaknesses and Suggestions

Control over carcasses is not being established until completion of processing. Control should be established when the animals are received and should be continued through sale of the processed carcasses.

Costs of acquiring and processing livestock should be accumulated by lot, and the numbers and weights of processed carcasses should be related to numbers and weights of the animals originally purchased. This will provide control over processing costs, prevent unwarranted material losses during processing, and provide a check on the quality of the suppliers whose livestock is included in a particular lot.

Note 4

a. Objective

To safeguard Company assets by adequately preserving and protecting inventory against deterioration and theft.

b. Weaknesses and Suggestions

Physical safeguards for the carcasses are inadequate. Guard service is not continuous, and apparently the cooler is sometimes unattended during the working day. The cooler should be kept locked at all times when not under close surveillance; responsibility for seeing that this is done should be specifically assigned.

It would be desirable to relocate the cooler in a less vulnerable place, outside the flow of traffic and perhaps within the plant. A burglar alarm system or guard protection in off-work hours should also be considered.

Note 5

a. **Objective**

To safeguard Company assets, improve the reliability of accounting data, promote operational efficiency and encourage adherence to prescribed managerial policies by establishing control over the quantities of by-products produced and sold.

b. **Weaknesses and Suggestions**

No physical controls have been established over either the production or sale of by-products. As by-products are substantial, controls should be established over production, inventory and sales. The production of by-products in each lot should be related to standard quantities based on established ratios between by-products and animals processed. Perpetual inventory records of important by-products should be established and reconciled to periodic physical inventories.

BUSINESS LAW
(Commercial Law)

November 6, 1970; 8:30 a.m. to 12:00 m.

Answer 1

1.	False	11.	True	21.	False
2.	True	12.	True	22.	True
3.	False	13.	True	23.	True
4.	False	14.	True	24.	False
5.	False	15.	False	25.	False
6.	True	16.	False	26.	True
7.	True	17.	False	27.	True
8.	False	18.	True	28.	True
9.	True	19.	False	29.	False
10.	True	20.	True	30.	False

Answer 2

31.	True	41.	True	51.	False
32.	True	42.	False	52.	False
33.	False	43.	True	53.	True
34.	True	44.	False	54.	False
35.	False	45.	True	55.	True
36.	False	46.	False	56.	False
37.	False	47.	False	57.	False
38.	False	48.	True	58.	False
39.	True	49.	False	59.	False
40.	False	50.	True	60.	True

Answer 3

61. False	71. False	81. False
62. True	72. True	82. True
63. False	73. True	83. True
64. False	74. True	84. True
65. False	75. False	85. False
66. True	76. True	86. True
67. True	77. True	87. True
68. True	78. True	88. False
69. True	79. False	89. False
70. False	80. False	90. True

Answer 4

a. Yes. Despite Wells' total lack of authority the contract he made with Arista may be ratified by Fantastic Fan. The elements necessary in order for Fantastic Fan to invoke the ratification doctrine are as follows:

1. The unauthorized agent must purport to act for and on behalf of the principal. Wells did so in his dealings with Arista.
2. There must have been a principal in existence at the time the contract was made who had the capacity to appoint an agent to enter into the contract. Fantastic Fan was in existence and could have appointed Wells to make the contract.
3. The principal must ratify the contract prior to the third party withdrawing from or repudiating the contract. Fantastic Fan did so. Thus, Arista is bound on the contract made by Wells on Fantastic Fan's behalf.

b. No. Although Williamson had no actual authority to make the contract, Fantastic Fan is liable on the basis of Williamson's apparent authority. This authority is based upon Williamson's position as a general purchasing agent and the fact that similar purchases had been made by Williamson in prior years. Limitations on an agent's usual authority are not binding on third parties who deal with the agent without knowledge or notice of such limitations.

c. No. The law imposes broad liability upon the principal for the torts of his agent, but there is an exception which would apparently apply here, the "independent frolic" rule. When the agent has abandoned his employer's calling and independently engages in an activity unrelated and entirely outside the scope of his employment, the law does not hold the principal liable. Anthony's behavior seems to be clearly within this exception.

d. The cargo company can rescind the contract for a breach of warranty and/or fraud and obtain damages for injury to the computer equipment. A principal is liable for the misrepresentations made by his agent either on a warranty theory, in which case knowledge of falsity need not be proved, or on the tort of fraud where the agent has the requisite knowledge that his representation is false. Under both theories the cargo company may recover damages and rescind the contract.

Answer 5

a. Yes. The situation is covered by the Securities Act of 1933. That Act made significant changes in the legal liability of accountants. First, it eliminated privity as a defense in cases involving third party investors suing accountants for negligence. Any person acquiring securities described in the registration statement may sue if the financial statements contain a false statement or misleading omission of a material fact. Clearly, the financial statements in question contained either a false statement or material omission. However, the CPA may avoid liability if he can show freedom from negligence or fraud by showing that he had, after reasonable investigation, grounds to believe and did believe the financial statements were true. The Act requires, however, that the CPA be able to sustain this freedom from fault not only as of the date of the financial statements, but beyond that, as of the time when the registration statement became effective. In this case it would appear that the CPA firm cannot avoid liability. It failed to make any reasonable effort to verify the validity of the statements as of the effective date. Merely taking the word of the Company's executives would not be sufficient. Thus liability may be imposed upon the accountants, May, Clark & Company. The Corporation and its officers will also be liable.

b. 1. Yes, but only to the extent of $35,000. The original $25,000 loan by Busch Factors was in no way related to the negligently prepared financial statements. This $25,000 loan was made prior to the issuance of the unqualified auditor's report. Hence, there is no causal relationship between the negligence of the CPAs and this portion of the loss.

As to the $35,000 loan, the requisite causal relationship was clearly present. The problem here lies in the ancient privity-of-contract requirement which holds that a CPA is not liable to third parties (with whom he has not contracted) for mere negligence. However, there are several exceptions to the privity rule which permit recovery despite the absence of a direct contractual relationship between the accountant and the third party plaintiff. The exception which would apply in this case is the primary benefit or third party beneficiary rule. This rule is invoked when the accountant is informed of the specific person or persons for whose primary benefit the audit is being performed. Under these circumstances privity is not required, and a third party such as Busch can recover for mere negligence as a third party beneficiary.

2. No. Unless the privity requirement is subjected to further substantial inroads or is abolished altogether, Maxwell will not recover. As indicated above, in the absence of a direct contractual relationship or an exception to the privity rule, recovery by a third party plaintiff against the accountant for mere negligence is not permitted. The primary benefit rule would not seem applicable as applied to the facts of the Maxwell situation. Therefore, recovery would be denied.

Answer 6

a. Simpson's death causes the dissolution of the partnership. However, the partnership is not terminated but continues until the winding up of partnership affairs is completed.

b. Walker has the right to wind up partnership affairs or to complete transactions begun but not finished at the time of Simpson's death. Walker is entitled to reasonable compensation for his services.

c. Mrs. Simpson has no interest in specific partnership property. Mr. Simpson's co-ownership in partnership property did not pass to Mrs. Simpson upon his death; it ceased to exist upon his death, and the ownership of the partnership property remains exclusively with the surviving partner. What passes to Mrs. Simpson is the interest of the deceased in the partnership, and she has a right to insist that the partnership be wound up. However, she has no right to participate in either the winding up of the business or the management of the partnership. She is entitled to receive an accounting from the surviving partner, a right which accrues from the date of Mr. Simpson's death unless there is an agreement to the contrary. She is also entitled to share in the distribution of the proceeds of liquidation.

d. The partnership is liable; all partners are liable jointly for all debts and obligations of the partnership. Subject to the prior payment of Simpson's and Walker's separate debts, their individual properties are liable for all obligations that the partnership incurred while each was a partner. Thus, the Estate and Walker must satisfy all personal claims before Norris' claim against the partnership can be satisfied. When a partner pays a partnership debt he has a right to a contribution from his copartner.

e. Overton may not attach the partnership property to satisfy his personal judgment against Walker. A partner's right in specific partnership property is not subject to attachment or execution, except on a claim against the partnership. The court, however, may charge the partnership interest of the debtor partner with payment of the unsatisfied amount of such judgment.

Answer 7

a. 1. The legal implications of these facts relate to whether the original contract between Terminal and Polar Bear was assignable. The answer to this question depends on whether there was a material change in Terminal's obligation as a result of the purported assignment.

As a general rule, most contractual rights to receive a commonplace item, such as ice, are assignable. However, the courts are reluctant to uphold the assignment of rights where there is a requirements contract which obligates the seller to supply a purchaser's particular requirement for a product and the buyer to buy exclusively from a particular seller.

In the past, such rights were considered too personal to be assignable. According to the modern view, which has been codified in the Uniform Commercial Code, the validity of an assignment is determined by the effect that the assignment will have on the performance of the obligor's (Terminal's) duty. If the court concludes that the obligor's performance will be materially altered, the assignment is invalid.

In this case, Polar Bear and Terminal had been doing business for three years prior to the renewal of the contract. The prior dealings, Polar Bear's geographic market, the size of Polar Bear's plant and other factors surrounding the relationship made fairly certain the average quantity of ice to be purchased over the term of the contract. Now Igloo, a much larger ice cream company, will be the buyer. It is unlikely that Igloo's demands will be the same as those of its predecessor. It could purchase no ice from Terminal for given periods and still supply the Polar Bear Market by manufacturing ice cream at one of its other nearby plants. This would tend to be most profitable to Igloo if the market price of ice were to decrease below that of the assigned contract. On the other hand, if the price of ice in the area of either company were to rise above that in the assigned contract, Igloo would take the maximum, 250 tons, every week of the contract and ship ice cream to its other markets. Based upon these considerations, the change in parties would represent a material change in the seller's (Terminal's) obligation and hence the contract would not be assignable.

The legal problem raised by the delegation of the duty by Polar Bear to Igloo to pay for the ice would apparently be overcome in that Igloo offered to pay cash on delivery thereby eliminating any extension of credit. Delegation of the duty to pay which involves extension of unsecured credit is normally permitted only with the consent of the seller.

2. An opinion letter from counsel should be obtained and a footnote to the financial statements should be prepared in conformity with the opinion letter.

b. 1. The following issues are raised by these facts:
 a. Was the acceptance made within the time stipulated for acceptance in the offer?
 b. Did the variations contained in the acceptance constitute a rejection of the offer and, hence, a counter-offer?
 c. Assuming that a contract between Williams Watch and Jackson Watch Band did arise, what remedies are available to Williams Watch?
 d. Must Williams Watch perform its contract with Promotions, Inc.?

The acceptance was made by mail, an authorized means which was reasonable in the circumstances. When an authorized means is used, the Uniform Commercial Code provides that a timely acceptance is effective at the time of dispatch. The acceptance was posted on October 15; it was timely and effective.

The minor variations do not prevent the creation of the contract under the Code. They are treated as mere proposals to the offeror which he may accept or reject. The letter of October 17 may be construed as rejecting the proposed modifications, but the variations do not prevent a valid acceptance from taking place upon posting of the letter on October 15.

The conduct of Jackson Watch appears to constitute an anticipatory repudiation of the contract, i.e., it has repudiated with respect to a performance not yet due.

The Code provides that the aggrieved party (Williams) may suspend its own performance. In addition it may: (1) for a commercially reasonable time await performance; (2) "cover," i.e., purchase substitute goods in the market and recover from Jackson the difference between the price paid to cover (presumably $8.75) and the contract price ($7.26); or (3) recover damages based on the difference between the market price at the time the buyer learns of the breach (again presumably $8.75) and the contract price.

The remedy of specific performance would not be available to Williams Watch.

Williams Watch has an enforceable contract with Promotions, Inc. and will be liable for breach of contract if it fails to perform. Neither the fact that it was relying on Jackson Watch Band to perform nor the sharp price rise will permit Williams Watch to avoid its obligation.

2. The implications of these problems must be considered by Williams Watch in preparing its financial statements. The treatment to be given them will depend upon the legal approach taken by Williams Watch and the outcome anticipated by legal counsel. As a minimum, details of the contracts and counsel's opinion as to possible legal liability should be shown in a footnote. If the loss anticipated in fulfilling the Promotions, Inc. contract is expected to exceed the net recovery to be made from Jackson Watch, provision should be made for the excess.

Answer 8

a. 1. The check was order paper because it was payable to the order of a named payee, even though the payee was a fictitious or nonexisting person. The Uniform Commercial Code changes the rule under the Uniform Negotiable Instruments Law which held that such a check was bearer paper.

2. Yes. When a check is made payable to the order of a payee, anyone can endorse the payee's name to make the endorsement effective. This is true even though the payee's name was supplied by an employee of the drawer and the employee intended that the named payee have no interest in the check.

3. Yes. Because Martin's endorsement was effective to negotiate the check to Smith, Smith acquired valid title to the check. Since he is a holder in due course he may recover against Franklin. This does not, of course, affect the criminal or civil liability of Martin, the person wrongfully endorsing the name of another.

b. 1. Yes. There was a material alteration by Evans, a holder, which discharges prior parties except a subsequent holder in due course. Since Mark is a holder in due course, Lawrence is not discharged as to him, and Mark may recover against Lawrence.

2. Mark, as a holder in due course, can recover according to the original tenor of the check, $1,000. If Lawrence had, by his negligence, substantially contributed to the alteration he would be precluded from asserting the defense of material alteration and would be liable for $10,000. However, since he used due care in preparing the check he is liable only according to its original tenor.

c. 1. Smith can compel State Bank to credit his account for $500 since the State Bank, as drawee, did not pay Hodys as Smith had directed.

2. Hodys, as rightful owner of the check, has a claim in conversion against State Bank which, as drawee bank, paid the check on a forged endorsement.

3. State Bank has paid the collecting bank, National Bank. State Bank may recover $500 from National Bank for breach of warranty since National Bank warranted that all prior signatures were genuine and valid.

ACCOUNTING THEORY
(Theory of Accounts)

November 6, 1970; 1:30 to 5:00 p.m.

Answer 1

1.	b	11.	c
2.	c	12.	a
3.	d	13.	d
4.	a	14.	b
5.	c	15.	b
6.	b	16.	d
7.	d	17.	a
8.	c	18.	d
9.	a	19.	c
10.	b	20.	a

Answer 2

a. The preferable treatment of the costs of the sample display houses is expensing them over more than one period. These sample display houses are assets because they represent rights to future service potentials or economic benefits. According to the matching concept, the costs of service potentials should be amortized as the benefits are received. Thus costs of the sample display houses should be matched with the revenue from the sale of the houses which is receivable over a period of more than one year. As the sample houses are left on display for three to seven years, Kwik-Bild Corporation apparently expects to benefit from the displays for at least that length of time.

The alternative of expensing the costs of sample display houses in the period in which the expenditure is made is based primarily upon the concept of conservatism. These costs are of a promotional nature. Promotional costs often are considered expenses of the period in which the expenditures occur due to the uncertainty in determining the time periods benefited. It is likely that no decision is made concerning the life of a sample display house at the time it is erected. Past experience may provide some guidance in determining the probable life. A decision to tear down or alter a house probably is made when sales begin to lag or when a new model with greater potential becomes available.

There is uncertainty not only as to the life of a sample display house but also as to whether a sample display house will be torn down or altered. If it is altered rather than torn down, a portion of the cost of the original house may be attributable to the new model.

b. If all of the shell houses are to be sold at the same price, it may be appropriate to allocate the costs of the display houses on the basis of the number of shell houses sold. This allocation would be similar to the units-of-production method of depreciation and would result in a good matching of costs with revenues. On the other hand, if the shell houses are to be sold at different prices, it may be preferable to allocate costs on the basis of the revenue contribution of the shell houses sold.

There is uncertainty regarding the number of homes of a particular model which will be sold as a result of the display sample. The success of this amortization method is dependent upon accurate estimates of the number and selling price of shell houses to be sold. The estimate of the number of units of a particular model which will be sold as a result of a display model should include not only units sold while the model is on display but also units sold after the display house is torn down or altered.

Cost amortization solely on the basis of time may be preferable when the life of the models can be estimated with a great deal more accuracy than can the number of units which will be sold. If unit sales and selling prices are uniform over the life of the sample, a satisfactory matching of costs and revenues may be achieved if the straight-line amortization procedure is used and the cost of capital is ignored.

Answer 3

a. 1. Convertible debt securities are convertible into common stock of the issuer at a specified price per share at the option of the holder, usually are callable at the option of the issuer and usually are subordinated to nonconvertible debt. The convertible debt securities generally command (1) an effective interest rate which is lower than the issuer could establish for nonconvertible debt, (2) an initial conversion price which is greater than the market value of the common stock at time of issuance and (3) a conversion price which does not decrease except pursuant to antidilution provisions.

2. Debt issued with stock purchase warrants is both a debt security and an option or a right to purchase stock (usually common) of the issuer for a specified time at a specified price per share. The provisions of the debt

agreement usually are more restrictive on the issuer and more protective of the investor than those for convertible debt and the warrants usually are added to make the debt financing successful. If detachable, the warrants usually trade separately from the debt security.

b. 1. Convertible debt and debt with stock purchase warrants are similar in that (1) both allow the issuer to issue debt at a lower interest cost than would generally be available for nonconvertible debt; (2) both allow the holders to purchase the issuer's stock at less than market value if the stock appreciates sufficiently in the future; (3) both provide the holder the protection of a debt security if the value of the stock does not appreciate and (4) both are complex securities which contain elements of debt and equity at the time of issue.

2. Convertible debt and debt with stock purchase warrants are different in that (1) if the market price of the stock increases sufficiently, the issuer can force conversion of convertible debt into common stock by calling the issue for redemption but he cannot force conversion of the warrants; (2) convertible debt may be essentially equity capital whereas debt with stock purchase warrants is debt with the additional right to acquire equity and (3) the conversion option and the convertible debt are inseparable and, in the absence of separate transferability, do not have separate values established in the market; whereas debt with detachable stock purchase warrants can be separated into debt and the right to purchase stock, each having separate values established by transactions in the market.

c. 1. Differences of opinion exist as to the accounting treatment of convertible debt. One view is that the security should be treated by the issuer solely as debt.

The contrary view is that convertible debt possesses characteristics of both debt and equity and that separate accounting recognition should be given to the debt characteristics and to the conversion option at time of issuance. This view is based upon the premise that there is an economic value inherent in the conversion feature which is an option to buy (or a call on) the stock and that the nature and value of this feature should be recognized for accounting purposes by the issuer. Under this view a portion of the proceeds attributable to the conversion feature should be accounted for as paid-in capital.

2. It is preferable to treat convertible debt solely as debt. The primary reason for this treatment is the inseparability of the debt and the conversion option. A convertible debt security is a complex hybrid instrument bearing an option, the alternative choices of which cannot exist independently of one another. The holder ordinarily does not sell one right and retain the other. The two choices are mutually exclusive.

Another reason for accounting for convertible debt solely as debt is that the valuation of the conversion option or the debt security without the conversion option presents measurement problems. These values are not established separately in the marketplace.

d. 1. A possible accounting treatment for the proceeds from debt issued with stock purchase warrants is to treat the proceeds solely as debt. The other treatment is to give separate recognition to the warrants.

2. The preferable treatment is to give separate recognition to the warrants. Unlike convertible debt, debt with detachable warrants to purchase stock is usually issued with the expectation that the debt will be repaid when it matures. Also, the detachable warrants often trade separately from the debt instrument. Thus the two elements of the security exist independently and may be treated as separate securities with the proceeds allocated to them for accounting purposes. The allocation should be based upon the relative fair values of the debt security without the warrants and of the warrants themselves at time of issuance. The portion of the proceeds so allocated to the warrants should be accounted for as paid-in capital. The remainder of the proceeds should be allocated to the debt security portion of the transaction. This usually results in issuing the debt security at a discount.

However, when stock purchase warrants are not detachable from the debt and the debt security must be surrendered in order to exercise the warrant, the two securities taken together are substantially equivalent to convertible debt and should be treated as described in part "c.2."

Answer 4

a. 1. Economic order quantity is that order size which minimizes the associated annual costs of the inventory.

2. The reorder point is that low point of stock level which when reached means a replenishing order should be placed.

3. Lead time is the interval between the placing of an order and delivery of the ordered goods.

4. Safety stock is the minimum inventory that provides a cushion against reasonably expected maximum demands and against variations in lead time.

b. 1. Common costs of carrying inventories include storage cost, handling cost, taxes, insurance, interest on the investment and obsolescence. Storage space may be rented or owned. If rented, the rental expense is an inventory carrying cost. If storage space is owned, storage cost may include property taxes, depreciation, insurance on the facilities and interest on the investment. Whether storage space is rented or owned, storage cost may include utility expenses and perhaps some labor (e.g., night watchman).

Handling cost may include the labor cost of unpacking, moving, counting and packing inventory items. Handling cost may also include the cost of supplies and the cost of using equipment in handling inventories.

Examples of carrying costs are (1) property taxes on inventories, (2) insurance to cover the risk of damage or theft of inventories and (3) interest (either imputed or explicit) on investment in inventories. A portion of office expense also may be considered an inventory carrying cost as clerical work is involved with inventory records.

2. Most of the costs are directly proportionate to the size of the inventory maintained. It follows, therefore, that to whatever extent overstocking exists, most inventory costs will be proportionately higher; it is likely that obsolescence costs will increase more than proportionately.

c. 1. The consequences of maintaining minimal or inadequate inventories include higher purchasing and transportation costs, loss of (1) repeat business or consumer goodwill, (2) quantity discounts and (3) sales (and their contribution margin.) In production situations, higher set-up costs, more overtime and higher training costs are costs of understocking. These increases may be partly offset by a lower cost of capital.

2. Some of the foregoing consequences cannot be measured with as much precision as the costs of overstocking. Measurement of the cost of lost orders and lost repeat business is not easy because measurement may be largely subjective. On the other hand, the other factors listed can be measured with fair certainty and greater ease.

d. 1. Following the theory of production, which states that values are created by changes in time, place and form utility, inventory cost includes applicable expenditures and charges directly or indirectly incurred in bringing an article to its existing condition and location. Thus, normal costs of carrying inventory should be included in inventory cost while excessive cost due to understocking or overstocking should be excluded because, like the costs of abnormal spoilage, they usually are considered to be losses.

There also is a problem of measurement. It frequently is difficult to measure the costs of carrying inventory because of the joint use of common facilities and the problem of apportionment between products. It also is difficult to measure the costs – both incurred and opportunity – of overstocking. Thus for external reporting, such costs frequently are excluded from inventoriable costs and treated as expenses or losses; usually only invoice costs plus freight are included.

2. For internal decision-making purposes, accountants are not constrained by requirements of the external double-entry model. Relevant costs include incurred as well as unincurred, unrecorded costs – imputed and other opportunity costs. Thus the unrecorded lost profits from under-stocking are as relevant to the inventory decision as the price paid for the merchandise acquired.

Answer 5

a. Intangible assets, like other monetary assets, represent rights to future benefits. An intangible asset is usually defined as a capital asset having no physical existence, its value being dependent upon the rights that possession confers upon the owner. The term "capital" implies they are noncurrent.

A few assets which fit the definition are not classified as intangible assets. For example, long-term receivables and long-term investments ordinarily are classified elsewhere in the balance sheet.

b. 1. A dollar to be received in the future is worth less than a dollar received today because of an interest or discount factor – often referred to as the time value of money. The discounted value of the expected royalty receipts can be thought of either in terms of the present value of an annuity of 1 or in terms of the sum of several present values of 1.

2. If the royalty receipts are expected to occur at regular intervals and the amounts are to be fairly constant, their discounted value can be calculated by multiplying the value of one such receipt by the present value of an annuity of 1 for the number of periods the receipts are expected. On the other hand, if receipts are expected to be irregular in amount or if they are to occur at irregular intervals, each expected future receipt would have to be multiplied by the present value of 1 for the number of periods of delay expected. In each case some interest rate (discount factor) per period must be assumed and used. As an example, if receipts of $10,000 are expected each six months over the next ten years and an 8% annual interest rate is selected, the present value of the twenty $10,000 payments is equal to $10,000 times the present value of an annuity of 1 for 20 periods at 4%. Twice as many periods as years and half the annual interest rate of 8% are used because the payments are expected at semiannual intervals. Thus the discounted (present) value of these receipts is $135,903 ($10,000 x 13.5903). Because of the interest rate, this discounted value is considerably less than the total expected collections of $200,000. Continuing the example, if instead it is expected that $10,000 will be received six months hence, $20,000

one year from now, and a terminal payment of $15,000 is expected 18 months hence, the calculation is as below:

$10,000 x present value of 1 at 4% for 1 period = $10,000 x .96154
$20,000 x present value of 1 at 4% for 2 periods = $20,000 x .92456
$15,000 x present value of 1 at 4% for 3 periods = $15,000 x .88900

Adding the results of these three calculations yields a total of $41,441 (rounded), considerably less than the $45,000 total collections, again due to the discount factor.

c. The basis of valuation for the patents that is generally accepted in accounting is cost. Evidently the cartons were developed and the patents obtained directly by the client corporation. Therefore, their cost would include applicable experimental and developmental costs, government and legal fees and the costs of any models and drawings. The proper initial valuation would be the sum of these costs plus any other costs incident to obtaining the two patents. This is in accord with the accounting principle that the initial valuation of any asset generally includes virtually all costs necessary to acquire and make it ready for normal use. Such values are objectively determined and rest upon actual completed transactions rather than upon estimates and future expectations.

d. 1. Intangible assets represent rights to future benefits. The ideal measure of the value of intangible assets is the discounted present value of their future benefits. For the Vandiver Corporation, this would include the discounted value of expected net receipts from royalties as suggested by the financial vice-president as well as the discounted value of the expected net receipts to be derived from the Vandiver Corporation's production. Other valuation bases that have been suggested are current cash equivalent or fair market value.

2. The amortization policy is implied in the definition of intangible assets as rights to future benefits. As the benefits are received by the firm, the cost or other value should be charged to expense or to inventory to provide a proper matching of revenues and expenses. Under the discounted value approach the periodic amortization would be the decline during the year in the present value of expected net receipts.

e. The litigation can and probably should be mentioned in notes to the financial statements. Some indication of the expectations of legal counsel in respect to the outcome can properly accompany the statements. It would be inappropriate to record a contingent asset reflecting the expected damages to be recovered. Costs incurred to September 30, 1970 in connection with the litigation should be carried forward and charged to expense (or to loss if the cases are lost) as royalties (or damages) are collected from the parties against whom the litigation has been instituted; however, the conventional treatment would be to charge these costs as ordinary legal expenses. If the final outcome of the litigation is successful, the costs of prosecuting it should be capitalized. Similarly, if the client were the successful defendant in an infringement suit on these patents, the generally accepted accounting practice would be to add the costs of the legal defense to the Patents account.

Developments to the time that the statements are prepared and released can be reflected in notes to the statements as a post-balance-sheet (or subsequent event) disclosure.

Answer 6*

a. When the assets of one firm are acquired by a second firm by the payment of cash or the exchange of other assets, the business combination is a purchase and therefore the business combination of Beach Corporation and Cedar Company is a purchase. Business combinations often are more complicated and the distinction between a purchase and a pooling of interests is not always clearcut.

The following circumstances, all of which interrelate with accounting concepts of entity, are indicative of a purchase rather than a pooling of interests: (1) the elimination of an important part of the ownership interests in the acquired firm; (2) a material alteration of the voting rights of the constituent corporations; (3) the elimination or reduction of the influence of the management of one of the constituents and (4) the dominance of one of the constituent corporations.

The following circumstances, all of which interrelate with accounting concepts of entity, are indicative of a pooling of interests: (1) continuance of the former ownership; (2) continuity of voting rights and consequent control over management; (3) continuity of management; (4) engagement in activities that are either similar or complementary and (5) comparability of size. The only criterion that has not been completely eroded in practice is the continuance of ownership.

However, the distinction between a purchase and a pooling of interests is usually based upon a substantial change of ownership or the absence of such a change.

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* This answer does not reflect the following relevant sources that did not become available until after the booklets for this examination had been approved for printing.

AICPA, Opinions of the Accounting Principles Board No. 16, "Business Combinations" (1970).

AICPA, Opinions of the Accounting Principles Board No. 17, "Intangible Assets" (1970).

b. 1. Goodwill may arise in a purchase. The total cost of an entity should be allocated to specific assets wherever possible, and any excess of purchase price over net asset values should be considered purchased goodwill or other intangibles. Goodwill results from the expectation of above average or superior earnings from the identifiable tangible and other intangible assets. Although resources and property rights can be separated from a business, goodwill has no value outside the related business operations.

2. The values attributable to the separable resources and property rights may exceed the value of a business as a whole. In some business combinations, the consideration given is presumably less than the fair value of the net resources and property rights acquired; the difference often is referred to inappropriately as "negative" goodwill. However, for most business combinations of the past several years it probably would be difficult to demonstrate that the net value of the separable assets of a business was greater than the consideration given for the entire business.

c. 1. In a purchase transaction, assets are recorded at their acquisition price which becomes the cost basis to the acquiring corporation. The book values of the assets for Cedar Company are irrelevant.

2. When a price is paid for a group of assets, the total price must be allocated to the individual assets. Because we know neither the total fair market value of the tangible and other intangible assets acquired from Cedar Company nor the price to be paid by the Beach Corporation, we cannot determine whether Beach has any goodwill to record. The total price to be paid by the Beach Corporation is indefinite but it may be estimated by discounting the expected receipts (1% of net sales) at the end of each of the next five years and adding the initial $450,000 cash payment. If the estimated purchase price exceeds the sum of the estimated fair values of the tangible and other intangible assets purchased, then the excess may be recorded as goodwill.

Answer 7

a. & b. The weaknesses in the Statement of Financial Position for Linus Construction Company and preferable accounting treatments are:

1. *Materials, supplies, labor and overhead charged to construction.* The balance of this work in progress inventory account includes actual costs incurred to date (per entry a) plus accrued profits (per entry b) while accounts receivable are carried at cost until the job is completed. Thus the Company is reflecting a balance in this inventory account which might be proper under the percentage-of-completion method. At the same time, it reports a substantial balance under Deferred Liabilities in the account, Unearned Revenue on Work in Progress. Clearly, a hybrid accounting procedure is in use which should be explained by a footnote, or the

statement should be modified to reflect the completed contract method. If the balance in the Unearned Revenue on Work in Progress account is retained, the portion reflecting anticipated profits should be reclassified and presented as a contra account to Materials, Supplies, Labor and Overhead Charged to Construction. The reductions in the Accounts Receivable account for collections from customers might be classified as an advance and given an appropriate title.

2. *Materials and supplies not charged to construction.* The basis of valuation of this inventory account (e.g., cost and how arrived at) should be disclosed.
3. *Deposits made to secure performance of contracts.* Since the first item of additional data suggests that the firm's operating cycle is 18 months, this account appears to be properly classified. Only to the extent that these deposits are not available for meeting obligations properly classified as current should this account be reported under some noncurrent asset category, such as Other Assets or Investments and Funds.
4. *Depreciation and value.* Use of these terms in the Property, Plant and Equipment caption is not ideal. "Less accumulated depreciation" or "less depreciation recorded to date" would be more suitable. Substitution of "book value" or "carrying value" for "value" would be desirable since the word "value" standing at the head of the column alone may connote that the amounts shown are current or realizable values.
5. *Land and buildings* should not be presented as a single lump-sum item; the cost of each asset may be significant and only the buildings are subject to depreciation.
6. *Payments made on leased equipment.* The explanation given indicates that this is an unusual item; thus a note or footnote presenting the essential facts should be incorporated in the statement. The descriptive item and $230,700 amount (or perhaps 70% thereof) should be reported under Other Assets since the assets to which the payments pertain have not been purchased as of the date of the statement. The $1 nominal carrying value is improper and the $230,699 should be eliminated from the statement. Because your client should use a completed-contract basis and because the normal operating cycle probably is around 18 months rather than the usual 12 months, it seems appropriate to classify the $230,700 (or 70% thereof) as an asset rather than as an expense. Under the matching concept, it is not necessary to know the amount of the expense until the amount of the revenue is known, which will be upon completion of a contract. At that time, the client makes a decision concerning the purchase of equipment. If the equipment is not purchased, the total lease rental payments are expensed. If purchased, the purchase price is recorded as an asset and the appropriate depreciation expense is recognized.

7. *Prepaid taxes and other expenses* were once properly reported as a deferred charge and the practice has not wholly disappeared. A preferred classification would be Current Assets.
8. *Points charged on mortgage note* are in reality a discount which raises the effective interest rate on the note. Such discounts should be accounted for in the same manner as discounts on bonds payable and preferably are shown as contra items under Liabilities.
9. *Deferred liabilities* is apparently a substitute for terminology such as Long-Term Liabilities; use of the latter is preferable.
10. *Mortgage note payable.* Both the interest rate and maturity date should be shown. The security for the note also should be disclosed.
11. *Unearned revenue on work in progress.* As noted under number 1 above, the portion representing anticipated profits should either be reported in a contra account to Materials, Supplies, Labor and Overhead Charged to Construction or be eliminated from the statement. The balance of this account may be reclassified as Partial Billings on Construction in Progress.
12. *6% preferred stock at par value* is inadequately presented. No indication is given as to the number of shares authorized or issued or as to the way(s) in which the stock is preferred. Similarly, details as to dividends, such as participation, cumulation and arrearages have been omitted.
13. *Common stock at par value* does not indicate the number of shares authorized and issued; these details should be reported.
14. *Paid-in surplus* is now regarded as obsolete terminology; "capital contributed in excess of par" or "premium on capital stock" would be more suitable titles. Further, there is no indication as to whether all of the balance relates to preferred stock, to common, or both.
15. *Treasury stock at cost—370 shares* should identify the class or classes of shares represented. A possible question which arises in connection with such stock is whether there also should be an appropriation of retained earnings. Laws of some states make such an appropriation mandatory; discretionary appropriation is a possibility in other jurisdictions.

Solutions and Answers to Examination May 1971

ACCOUNTING PRACTICE—PART 1

May 5, 1971; 1:30 to 6:00 p.m.

Solution 1

1. d
2. e
3. d
4. b
5. a
6. a
7. e
8. d
9. e
10. c
11. d
12. b
13. a
14. b
15. c
16. e
17. a
18. b

Solution 2

a.

Cazy Corporation

SCHEDULE TO COMPUTE TAXABLE INCOME

For 1970

Net income before suspense items		$ 98,400
Add:		
Income on sale of typewriters	$ 1,280	
Nondeductible depreciation expense on machines	2,200	
Net gain on capital transactions	1,100	
Dividend from Rab Corporation	4,200	8,780
		107,180
Deduct loss on investment in Del Corporation		22,500
Net profit before contribution and special deductions		84,680
Deduct contributions		884
Taxable income before special deductions		83,796
Less special deductions:		
Net operating loss carryover	67,000	
Dividend received deduction (85% of $4,200)	3,570	70,570
Taxable income after special deductions		$ 13,226

Computation of Income on Sale of Typewriters

Original cost of typewriters	$ 5,000
Less accumulated depreciation	2,600
Adjusted basis (book value)	$ 2,400

Ratio of sale proceeds to the total value of the property 3200/4000 = 80%

Allocation of Cost Basis

	80%	*20%*	*100%*
Cost basis	$1,920	$480	$2,400
Fair market value	3,200	800	4,000
Income on sale of typewriters	$1,280	$320	$1,600

$1,280 represents ordinary income on the sale
320 represents donated appreciation
480 represents charitable contribution

Computation of Net Gain on Capital Transactions

Original cost of building—Oldsville	$ 52,000
Less accumulated depreciation	21,000
Adjusted basis (book value)	31,000
Assumption of mortgage	34,000
Long-term capital gain on transfer of building	3,000
Less net long-term capital loss on marketable security transactions	6,400
Net long-term capital loss	3,400
Less net short-term capital gain	4,500
Net gain from capital transactions	$ 1,100

Computation of Contribution Deduction

Net profit before contributions and special deductions		$ 84,680
Less net operating loss carryover from 1969		67,000
Net income subject to contribution deduction limitation		$ 17,680
Maximum contribution deduction ($17,680 × 5%)		$ 884
Total contributions:		
Accrued contribution	$2,500	
Contribution resulting from sale of typewriters at less than fair market value	480	2,980
Contribution carryover		$ 2,096

b.

Cazy Corporation

SCHEDULE TO COMPUTE ACCUMULATED EARNINGS AND PROFITS

As of December 31, 1970

Accumulated earnings and profits, January 1, 1970		$ 8,340
Add:		
Taxable income before special deductions	$83,796	
Life insurance proceeds	40,000	
Interest on municipal obligations	1,300	
Bad debt recovery	550	125,646
		133,986
Deduct:		
Contribution carryover	2,096	
Life insurance premium ($2,900-$1,200)	1,700	3,796
Accumulated earnings and profits, December 31, 1970		$130,190

Solution 3

Nolan-Paszkowski, Inc.
WORKSHEET FOR PREPARATION OF ACCRUAL BASIS FINANCIAL STATEMENTS
For 1970

	Balances January 2, 1970		*Summary and Adjusting Entries*		*Income Statement 1970*		*Balance Sheet December 31, 1970*	
	Debit	*Credit*	*Debit*	*Credit*	*Debit*	*Credit*	*Debit*	*Credit*
Cash	$ 50,000		(1) $131,740	(2) $151,895			$ 29,845	
Accounts receivable	12,400		(3) 6,300				18,700	
Merchandise inventory	23,000				$ 23,000	$ 24,500	24,500	
Unexpired insurance	350		(2) 825	(4) 975			200	
Land	15,000						15,000	
Buildings	20,000		(2) 4,600				24,600	
Accumulated depreciation—buildings		$ 7,000		(9) 400				$ 7,400
Equipment	8,000		(2) 18,000	(1) 5,000			21,000	
Accumulated depreciation—equipment		2,400	(1) 1,000	(9) 1,750				3,150
Accounts payable		17,300	(5) 8,621					8,679
Advances from customers		900	(6) 1,050	(1) 700				550
Salaries payable		600		(7) 995				1,595
Income taxes withheld		450		(7) 325				775
F.I.C.A. taxes payable		100		(7) 90				190
Capital stock		100,000						100,000
	$128,750	$128,750						

	Balances		*Summary and Adjusting Entries*		*Income Statement*		*Balance Sheet*	
	January 2, 1970				*1970*		*December 31, 1970*	
	Debit	*Credit*	*Debit*	*Credit*	*Debit*	*Credit*	*Debit*	*Credit*
Sales				(1) 130,000				
				(3) 6,300				
				(6) 1,050				
				(10) 650		138,000		
Sales discounts			(1) 1,520		1,520			
Sales returns and allowances			(1) 1,940		1,940			
Gain on sale of equipment				(1) 500		500		
Purchases			(2) 85,000	(5) 8,621	76,379			
Purchase discounts				(2) 1,150		1,150		
Purchase returns and allowances				(2) 1,800		1,800		
Salary expense			(2) 42,445					
			(7) 1,365		43,810			
F.I.C.A. tax expense			(2) 625					
			(7) 45		670			
Utilities			(2) 1,850		1,850			
Dividends on common stock			(2) 1,500					
			(8) 750				2,250	
Insurance expense			(4) 975		975			
Dividends payable				(8) 750				750
Depreciation expense—buildings			(9) 400		400			
Depreciation expense—equipment			(9) 1,750		1,750			
Bad debt expense			(10) 1,656		1,656			
Allowance for bad debts				(10) 1,006				1,006
Income tax expense			(11) 2,706		2,706			
Deferred income tax				(11) 451				451
Income tax payable				(11) 2,255				2,255
			$316,663	$316,663	156,656	165,950	136,095	126,801
Net income					9,294			9,294
					$165,950	$165,950	$136,095	$136,095

Nolan-Paszkowski, Inc.

SUMMARY AND ADJUSTING ENTRIES

For 1970
(Not Required)

(1)

Cash	$131,740	
Accumulated depreciation—equipment	1,000	
Sales discounts	1,520	
Sales returns and allowances	1,940	
Equipment		$ 5,000
Advances from customers		700
Sales		130,000
Gain on sale of equipment		500

To record cash receipts during 1970.

(2)

Unexpired insurance	825	
Building	4,600	
Equipment	18,000	
Purchases	85,000	
Salary expense	42,445	
F.I.C.A. tax expense	625	
Utilities	1,850	
Dividends on common stock	1,500	
Cash		151,895
Purchase discounts		1,150
Purchase returns and allowances		1,800

To record cash disbursements during 1970.
Salary expense is composed of net salaries, $38,620, income tax withheld, $3,200, and employees' shares of F.I.C.A. tax, $625.

(3)

Accounts receivable	6,300	
Sales		6,300

To adjust the accounts receivable year-end balance to $18,700.

(4)

Insurance expense	975	
Unexpired insurance		975

To adjust the unexpired insurance year-end balance to $200.

(5)

Accounts payable	8,621	
Purchases		8,621

To adjust the accounts payable year-end balance to $8,679.

(6)

Advances from customers	1,050	
Sales		1,050

To adjust the advances from customers year-end balance to $550.

(7)

Salary expense	1,365	
F.I.C.A. tax expense	45	
Income taxes withheld		325
F.I.C.A. taxes payable		90
Salaries payable		995

To adjust the salaries payable year-end balance to $1,595, income taxes withheld to $775, and social security taxes payable to $190.

(8)

Dividends on common stock	750	
Dividends payable		750

To record dividends declared but not paid.

(9)

Depreciation expense—buildings	400	
Depreciation expense—equipment	1,750	
Accumulated depreciation—buildings		400
Accumulated depreciation—equipment		1,750

To record depreciation expense for 1970.

(10)

Bad debt expense	1,656	
Allowance for bad debts		1,006
Sales		650

To record bad debt expense for the year (1.2% of total sales of $138,000) and to adjust gross sales for specific accounts already removed from accounts receivable.

(11)

Income tax expense	2,706	
Deferred income tax		451
Income tax payable		2,255

To record income tax expense and liabilities:

	22% Tax	*2½% Surcharge*	*Total*
Accounting income ($12,000)	$2,640	$66	$2,706
Taxable income ($10,000)	2,200	55	2,255
Deferred tax	$ 440	$11	$ 451

Solution 4

a. **Lowe Company**

SCHEDULE TO EVALUATE COMMON STOCK EQUIVALENT STATUS OF CONVERTIBLE SECURITIES AND OPTIONS

December 31, 1970

	Convertible Debentures	*Convertible Preferred Stock*	*Employee Stock Options*
Market price at date of issue	$100	$40	
Cash yield	5½%	2½%	
Bank prime interest rate at date of issue	7%	7%	
66⅔% thereof	4⅔%	4⅔%	
Common stock equivalent? (Yes, if cash yield is less than 66⅔% of bank prime interest rate at date of issue.)	No	Yes	Yes

b. **Lowe Company**

SCHEDULE TO COMPUTE WEIGHTED AVERAGE NUMBER OF SHARES

For 1970

Shares outstanding from January 1, 1970 (including 2,400,000 shares issued upon acquisition of Diane Corporation)		7,300,000
Shares issued upon conversion of 750,000 shares of preferred stock:		
Issued October 1, 1970 (300,000 × 1/4)	75,000	
Issued November 1, 1970 (1,200,000 × 1/6)	200,000	275,000
		7,575,000
Common stock equivalents:		
1,400,000 shares of convertible preferred stock issued April 2, 1970 (1,400,000 × 2 × 3/4)	2,100,000	
Less common shares applicable to 750,000 preferred shares converted during year and included under common stock (as calculated above)	275,000	1,825,000
Shares represented by options outstanding	500,000*	
Less shares assumed reacquired with proceeds (500,000 shares × \$20 exercise price = \$10,000,000; \$10,000,000 ÷ \$25 average market price = 400,000 shares)	400,000	100,000
		1,925,000
Weighted average number of shares for computation of primary earnings per share		9,500,000
Adjustments to calculate fully diluted earnings per share:		
Shares applicable to options based on year-end market price (no adjustment necessary since year-end price is same as average market price for the year)		
Shares applicable to convertible debentures assumed converted at January 1, 1970 ($\frac{\$20{,}000{,}000}{\$100} \times 5$)		1,000,000
Weighted average number of shares for computation of fully diluted earnings per share		10,500,000

* Although this is consistent with the use of a simple average of monthly prices when common stock prices do not fluctuate significantly, current practice would base this determination upon the average market price of the common stock during each three-month quarter included in the period being reported upon. Following the latter approach, the number of shares represented by options outstanding would be reduced by one-fourth to 375,000, the shares assumed reacquired with proceeds would be 283,333, the weighted average number of shares for computation of primary earnings per share would be 9,491,667 and the weighted average number of shares for computation of fully diluted earnings per share would be 10,491,667.

c. **Lowe Company**

SCHEDULE TO COMPUTE PRIMARY AND FULLY DILUTED EARNINGS PER SHARE

For 1970

	1. Primary Earnings Per Share	*2. Fully Diluted Earnings Per Share*
Net income before adjustment	$9,200,000	$9,200,000
Interest on debentures, net of 48% tax effect		572,000
Net income after adjustment	$9,200,000	$9,772,000
Weighted average number of shares	9,500,000	10,500,000
Earnings per share	$.968	$.931
Earnings per share (rounded)	$.97	$.93

Solution 5

19. b
20. a
21. a
22. b
23. c
24. d
25. a
26. d
27. a
28. b
29. c
30. e
31. e
32. d
33. d

Solution 6

a. **Wright Hospital**

SCHEDULE TO COMPUTE PROJECTED NUMBER OF PATIENT DAYS
For the Year Ending June 30, 1972

Type of Patient	*Total Patients*		*Type of Service*			
				Semi-Private		
	Regular	*Medicare*	*Private*	*Regular*	*Medicare*	*Ward*
Medical:						
Patients	1,890[1]	210[2]	189[3]	1,134[3]	210	567[3]
Average stay (days)			7	7	17	7
Patient days			1,323	7,938	3,570	3,969
Surgical:						
Patients	2,160[1]	240[2]	324[3]	1,620[3]	240	216[3]
Average stay (days)			10	10	15	10
Patient days			3,240	16,200	3,600	2,160
Total patient days			4,563	24,138	7,170	6,129

[1] (.90) × (Expected number of patients)
[2] (.10) × (Expected number of patients)
[3] (Expected number of patients) × (Applicable percentage)

b. **Wright Hospital**

SCHEDULE TO COMPUTE
PROJECTED OPERATING ROOM MAN-MINUTES

For the Year Ending June 30, 1972

	Number of Operations	*Time in Minutes* *Average*	*Total*	*Personnel Required*	*Man-Minutes*
Inpatient:					
Type A	960[4]	30	28,800	4	115,200
B	840[4]	45	37,800	5	189,000
C	360[4]	90	32,400	6	194,400
D	240[4]	120	28,800	8	230,400
Total inpatient	2,400				729,000
Outpatient:	180	20	3,600	3	10,800
Operating room man-minutes					739,800

[4] (2,400 patients) × (Last year's proportion for this type of operation)

c. **Wright Hospital**

SCHEDULE TO COMPUTE
PROJECTED GROSS REVENUE FROM ROUTINE SERVICES

For the Year Ending June 30, 1972

	Private	*Semi-Private*	*Ward*	*Total Charges*
Number of patient days	4,563	31,308	6,129	
Charge per day	× $40	× $35	× $25	
Revenue	$182,520	$1,095,780	$153,225	$1,431,525

d. **Wright Hospital**

SCHEDULE TO COMPUTE
PROJECTED GROSS REVENUE FROM OPERATING ROOM SERVICES

For the Year Ending June 30, 1972

Type of Patient	*Charge Per Minute*	*Man-Minutes*	*Revenue*
Inpatient	$.13	729,000	$94,770
Outpatient	.22	10,800	2,376
Revenue			$97,146

e.

Wright Hospital

SCHEDULE TO COMPUTE PROJECTED COST PER MAN-MINUTE FOR OPERATING ROOM SERVICES

For the Year Ending June 30, 1972

	Total Direct Expenses	*Maintenance of Plant*	*Operation of Plant*	*Administration*	*All Others*	*Total After Distribution*
General services:						
Maintenance of plant	$ 50,000	$(50,000)				
Operation of plant	27,500	2,500	$(30,000)			
Administration	97,500	5,500	2,000	$(105,000)		
All others	192,000	10,250	7,250	25,625	$(235,125)	
Revenue producing services:						
Operating room	68,440	1,500	3,500	3,750	18,810	$ 96,000
All others	700,000	30,250	17,250	75,625	216,315	1,039,440
Total	$1,135,440	$ —0—	$ —0—	$ —0—	$ —0—	$1,135,440

$96,000 ÷ 800,000 man-minutes = .12 cost per man-minute.

ACCOUNTING PRACTICE—PART II

May 6, 1971; 1:30 to 6:00 p.m.

Solution 1

1. d	9. d
2. c	10. d
3. b	11. c
*4. e	12. a
5. c	13. e
6. c	14. b
7. e	15. d
8. a	

* Item 4—In accordance with the Internal Revenue Code and Tax Regulations response "e" would be correct, but since the practical answer based solely upon the information given would be response "c", both may be considered correct.

Solution 2

16. e	25. a
17. b	26. c
18. a	27. d
19. c	28. c
20. c	29. b
21. e	30. e
22. b	31. a
23. d	32. b
24. d	33. a

Solution 3

Plainview Corporation

STATEMENT OF SOURCE AND APPLICATION OF FUNDS
ALL FINANCIAL RESOURCES

For The Year Ended December 31, 1970

Funds provided by:		
Operations:		
Net income after extraordinary items	$236,580	
Add noncash debits:		
Loss on retirement of 6% mortgage bonds	5,000	
Loss sustained by 80% owned subsidiary	17,920	
Depreciation expense	109,900	
Deferred income taxes	39,200	
Charge to expense for estimated casualty losses	11,300	$419,900
Less noncash credit:		
Correction of prior year's profits for depreciation		30,000
Net funds provided by operations		389,900
Other sources:		
Bond sinking fund	63,000	
Sale of 8% debentures	125,000	
Sale of treasury stock	6,000	
Sale of building (plant and equipment)	4,000	198,000
Total funds provided		$587,900
Funds applied to:		
Cash dividends	$130,000	
Retirement of mortgage bonds	315,000	
Purchase of machinery	28,000	
Payment of income tax deficiency	16,000	
Increase in working capital	98,900	
Total funds applied		$587,900

Computation of Loss on Retirement of 6% Mortgage Bonds

Proceeds from bond sinking fund		$ 63,000
Proceeds from sale of 8% debentures		125,000
Proceeds from sale of marketable securities		127,000
Payment to retire 6% mortgage bonds		315,000
Less carrying value of 6% mortgage bonds:		
Face value	$300,000	
Unamortized premium	10,000	310,000
Loss on retirement of 6% mortgage bonds		$ 5,000

Computation of Depreciation Expense

Plant and equipment (net), December 31, 1969			$1,534,600
Add:			
Machinery purchased		$28,000	
Charge to accumulated depreciation for disallowed depreciation of prior years		30,000	58,000
			1,592,600
Less:			
Book value of warehouse destroyed by fire			
Cost	$100,000		
Accumulated depreciation	65,000	35,000	
Book value of building sold		4,000	39,000
			1,553,600
Less plant and equipment (net), December 31, 1970			1,443,700
Depreciation expense for year			$ 109,900

Computation of Deferred Income Taxes

Deferred income taxes, December 31, 1970		$ 53,900
Add debits to account during the year:		
Charge for income tax deficiency	$16,000	
Charge for deferred taxes related to warehouse destroyed by fire	12,700	28,700
		82,600
Less deferred income taxes, December 31, 1969		43,400
Deferred income taxes accrued during year		$ 39,200

Computation of Charge to Expense for Estimated Casualty Losses

Allowance for estimated casualty losses, December 31, 1970		$ 74,000
Add charge for loss on warehouse destroyed by fire:		
Book value	$35,000	
Deferred tax credit	12,700	22,300
		96,300
Less allowance for estimated casualty losses, December 31, 1969		85,000
Charge to expense for estimated casualty losses		$ 11,300

Computation of Change in Working Capital During 1970

	Balances, December 31		*Increase or*
	1970	*1969*	*(Decrease)*
Current assets:			
Cash	$142,100	$165,300	$(23,200)
Marketable securities	122,800	129,200	(6,400)
Accounts receivable (net)	312,000	371,200	(59,200)
Inventories	255,200	124,100	131,100
Prepaid expenses	23,400	22,000	1,400
Current liabilities:			
Accounts payable	238,100	213,300	(24,800)
Notes payable—current	—	145,000	145,000
Accrued payables	16,500	18,000	1,500
Income taxes payable	97,500	31,000	(66,500)
Increase in working capital			$ 98,900

Solution 4

Hayhurst Company
SCHEDULE OF PROPOSED ADJUSTMENTS AND DISCLOSURES
Audit March 31, 1971

		Adjusting Journal Entries—Debit (Credit)							
Item Number	*Abbreviated Description of Item*	*Current Assets*	*Other Assets*	*Current Lia-bilities*	*Other Lia-bilities*	*Stock-holders' Equity*	*Income Statement*	*Footnote Disclosure*	*No Further Consid-eration*
1.	Accounts payable vouchers								
	a. Vo. 4-07 Albion Supply			$(1,200)			$ 1,200		
	b. Vo. 4-13 Skyview								✓
	c. Vo. 4-28 Albion Supply								✓
	d. Vo. 4-81 Hoosier		$ 3,450	(3,450)					
	e. Vo. 5-01 Acme Services			(600)			600		
	f. Vo. 5-06 Phelps and Cox			(750)			750		
2.	Collections of accounts receivable								✓
3.	Current maturities of serial bonds								✓
4.	Emory Company bankruptcy								✓
5.	Increase in April sales								✓
6.	Gregory bankruptcy							✓	
7.	Note payable to Second National Bank								✓
8.	Change in depreciation method								✓
9.	Actions by board of directors								
	a. Construction plans							✓	
	b. Loan to company president	(10,000)	10,000						
	c. Lease extension							✓	
10.	March issue slips	(7,000)					7,000		
11.	Interbank transfer								✓
12.	Legal letter								
	a. Patent infringement							✓	
	b. Legal fee on above		6,500	(6,500)					
	c. Suit on employment contract			(15,000)			15,000	✓	
	d. Personal injury suit								✓
	e. Revenue agents' examinations								✓
	f. March retainer fee due								✓
	Net effects of proposed adjustments	$(17,000)	$19,950	$(27,500)			$24,550		

Solution 5

Mr. and Mrs. Z. D. Danberry

WORKSHEET FOR ESTIMATED VALUE BASIS FINANCIAL STATEMENTS

For The Year Ended April 30, 1971

	Assets and Liabilities				*Estimated Value Basis April 30, 1971*		
			Summary and Adjusting Entries		*Statement of Changes in Net Assets*		*Statement of Net Assets*
	Cost Basis April 30, 1971	*Estimated Value Basis April 30, 1970*	*Debit*	*Credit*	*Debit*	*Credit*	
Assets							
Cash	$ 3,300	$ 6,120		(1)$ 2,820			$ 3,300
Marketable securities	23,000	21,400	(1)$ 8,000				26,900
			(4) 2,000	(1) 4,500			
Cash value of life insurance	4,250	3,900	(1) 350				4,250
Net assets of Danberry's dental practice	19,500	27,000	(3) 4,000				31,000
Interest in Dental Supply, Inc.	6,100	8,600	(3) 2,400				11,000
Residence	50,000	55,600	(5) 4,400				60,000
Automobiles	6,000	6,800		(5) 2,500			4,300
Paintings	11,000	12,700	(5) 1,800				14,500
Household furnishings	9,000	7,800		(5) 200			7,600
	$132,150	$149,920					

	Assets and Liabilities: Cost Basis April 30, 1971	Assets and Liabilities: Estimated Value Basis April 30, 1970	Summary and Adjusting Entries: Debit	Summary and Adjusting Entries: Credit	Estimated Value Basis April 30, 1971: Statement of Changes in Net Assets: Debit	Estimated Value Basis April 30, 1971: Statement of Changes in Net Assets: Credit	Estimated Value Basis April 30, 1971: Statement of Net Assets
Liabilities							
Accounts payable	$ 3,100	$ 2,850		(6) 250			(3,100)
Accrued income taxes payable	2,225	1,900		(7) 325			(2,225)
Accrued income taxes on unrealized asset appreciation		2,200		(8) 3,325			(5,525)
Mortgage payable	34,000	35,300	(1) 1,300				(34,000)
	$ 39,325	$ 42,250					
Personal costs			(1) 15,650				
			(6) 250		$15,900		
Income taxes			(1) 4,100				
			(7) 325		4,425		
Interest expense			(1) 1,400		1,400		
Real estate taxes			(1) 900		900		
Drawings from Danberry's dental practice				(1) 21,000		$21,000	
Gain on sale of securities				(1) 1,600		1,600	
Dividend income				(1) 1,540		1,540	
Interest income				(1) 240			
				(2) 120		360	
Accrued interest receivable			(2) 120				120
Increase in value of marketable securities				(4) 2,000		2,000	
Increase in value of net assets of Danberry's dental practice				(3) 4,000		4,000	
Increase in value of interest in Dental Supply, Inc.				(3) 2,400		2,400	
Decrease in value of automobile			(5) 2,500		2,500		
Decrease in value of household furnishings			(5) 200		200		
Increase in value of residence				(5) 4,400		4,400	
Increase in value of paintings				(5) 1,800		1,800	
Provision for income taxes on unrealized asset appreciation			(8) 3,325		3,325		
			$53,020	$53,020	28,650	39,100	
Increase in current value of net assets					10,450		
					$39,100	$39,100	$118,120

Mr. and Mrs. Z. D. Danberry
ADJUSTING ENTRIES
For The Year Ended April 30, 1971
(Not Required)

(1)

Personal costs	$15,650	
Cash value of life insurance	350	
Marketable securities—bonds	8,000	
Income taxes	4,100	
Interest expense	1,400	
Mortgage payable	1,300	
Real estate taxes	900	
Drawings from Danberry's dental practice		$21,000
Marketable securities—Inco Stock		4,500
Gain on sale of securities		1,600
Dividend income		1,540
Interest income		240
Cash		2,820

To adjust estimated realizable value basis accounts for cash transactions.

(2)

Accrued interest receivable	120	
Interest income		120

To record interest accrual on bonds.

(3)

Net assets of Danberry's dental practice	4,000	
Interest in Dental Supply, Inc.	2,400	
Increase in value of net assets of Danberry's dental practice		4,000
Increase in value of interest in Dental Supply Inc.		2,400

To record increase in value of business interests.

Danberry's dental practice:

Estimated realizable value, April 30, 1971	$31,000	
Less: Estimated realizable value, April 30, 1970	27,000	
Increase during year.	$ 4,000	

Dental Supply, Inc.:

Current assets	$30,000	
Fixed assets	70,000	$100,000
Less: Current liability	17,000	
Long-term liability	35,000	
Deferred credits	4,000	56,000
Net assets, April 30, 1971		$ 44,000
25% of net assets, April 30, 1971		$ 11,000
Less interest in net assets, April 30, 1970		8,600
Increase in interest in Dental Supply, Inc.		$ 2,400

(4)				
Marketable securities			2,000	
Increase in value of marketable securities since April 30, 1970				2,000
To record appreciation of marketable securities.				
Estimated realizable value of marketable securities, April 30, 1971		$ 26,900		
Less: Estimated realizable value of securities, April 30, 1970	$21,400			
Add cost of bonds purchased, July 31, 1970	8,000			
	$29,400			
Less: Estimated realizable value on April 30, 1970 of Inco stock sold during year	4,500	24,900		
Increase in estimated realizable value of marketable securities		$ 2,000		
(5)				
Residence			4,400	
Paintings			1,800	
Decrease in value of automobiles			2,500	
Decrease in value of household furnishings			200	
Increase in value of residence				4,400
Increase in value of paintings				1,800
Automobiles				2,500
Household furnishings				200
To record change in estimated realizable value of property owned.				
(6)				
Personal costs			250	
Accounts payable				250
To adjust for increase in accounts payable.				
(7)				
Income taxes			325	
Accrued income taxes payable				325
To adjust for increase during the year in accrued income taxes payable.				

(8)

Provision for income taxes on unrealized asset appreciation		3,325	
Accrued income taxes on unrealized asset appreciation			3,325
To record income tax accrual on unrealized asset appreciation.			
Increase in asset values:			
Marketable securities	$ 2,000		
Net assets of Danberry's dental practice	4,000		
Interest in Dental Supply, Inc.	2,400		
Residence	4,400		
Paintings	1,800		
Total increment during year	14,600		
$14,600 × 25% tax rate	3,650		
Less previously accrued taxes on unrealized gain on Inco stock sold during year	325		
Net increment	$ 3,325		

AUDITING

May 6, 1971; 8:30 a.m. to 12:00 m.

Answer 1

1. a	11. b
2. d	12. c
3. b	13. a
4. a	14. a
5. b	15. b
6. d	16. c
7. c	17. c
8. d	18. a
9. b	19. d
10. d	20. a

Answer 2

21. b	31. d
22. d	32. b
23. c	33. c
24. c	34. d
25. a	35. a
26. b	36. c
27. d	37. d
28. d	38. c
29. a	39. a
30. b	40. a

Answer 3

		Weakness	*Recommended Improvement*
a.	1.	Financial secretary exercises too much control over collections.	To extent possible, financial secretary's responsibilities should be confined to record-keeping.
	2.	Finance committee is not exercising its assigned responsibility for collections.	Finance committee should assume a more active supervisory role.

Weakness	*Recommended Improvement*
3. The auditing function has been assigned to the finance committee, which also has responsibility for the administration of the cash function. Moreover, the finance committee has not performed the auditing function.	An audit committee should be appointed to perform periodic auditing procedures or engage outside auditors.
4. The head usher has sole access to cash during the period of the count. One person should not be left alone with the cash until the amount has been recorded or control established in some other way.	The number of counters should be increased to at least two, and cash should remain under joint surveillance until counted and recorded so that any discrepancy will be brought to attention.
5. The collection is vulnerable to robbery while it is being counted and from the church safe prior to its deposit in the bank.	The collection should be deposited in the bank's night depository immediately after the count. Physical safeguards, such as locking and bolting the door during the period of the count, should be instituted. Vulnerability to robbery will also be reduced by increasing the number of counters.
6. The head usher's count lacks usefulness from a control standpoint because he surrenders custody of both the cash and the record of the count.	The financial secretary should receive a copy of the collection report for posting to the financial records. The head usher should maintain a copy of the report for use by the audit committee.
7. Contributions are not deposited intact. There is no assurance that amounts withheld by the financial secretary for expenditures will be properly accounted for.	Contributions should be deposited intact. If it is considered necessary for the financial secretary to make cash expenditures, he should be provided with a cash working fund. The fund should be replenished by check based upon a properly approved reimbursement request and satisfactory support.
8. Members are asked to draw checks to "cash," thus making the checks completely negotiable and vulnerable to misappropriation.	Members should be asked to make checks payable to the church. At the time of the count, ushers should stamp the church's restrictive endorsement (For Deposit Only) on the back of the check.

	Weakness	Recommended Improvement
	9. No mention is made of bonding.	Key employees and members involved in receiving and disbursing cash should be bonded.
	10. Written instructions for handling cash collections apparently have not been prepared.	Particularly because much of the work involved in cash collections is performed by unpaid, untrained church members, often on a short-term basis, detailed written instructions should be prepared.
b.	1. The envelope system has not been encouraged. Control features which it could provide have been ignored.	The envelope system should be encouraged. Ushers should indicate on the outside of each envelope the amount contributed. Envelope contributions should be reported separately and supported by the empty collection envelopes. Prenumbered envelopes will permit ready identification of the donor by authorized persons without general loss of confidentiality.
	2. The church maintains no permanent record of amounts pledged and contributed. These records are needed to (1) provide valid support for tax deductibility, (2) permit better planning for fund drives and (3) provide a basis for direct confirmation of amounts contributed.	A members' contribution record should be prepared by the financial secretary from the pledge cards and collection envelopes.
	3. No investigation is made of differences between the amounts pledged and contributed.	All members should be furnished with periodic written advice of the amounts pledged and contributed. If properly handled by the audit committee, this procedure can be combined with direct confirmation of the amount contributed. Not only will control be better, but members more likely will fulfill their pledges.

Weakness	Recommended Improvement
4. Letters certifying to amounts contributed are being furnished to members based upon the amounts shown on pledge cards. This is improper because actual contributions may not equal pledges.	The maintenance of the members' contribution record and the furnishing of periodic advices to members will correct this weakness.
5. No provision is made for the receipt of contributions by mail. This method of giving should be encouraged, but the financial secretary should not handle these receipts.	Mail should be opened by a church employee other than the financial secretary. This employee should list the receipts, maintain a copy of this listing and deposit the receipts. Checks should be stamped with the restrictive endorsement when received.

Answer 4

Note 1

a. The scope of the auditor's examination should be discussed in the auditor's report, not in the notes to the financial statements. Footnotes are management's representations and should not be written from the auditor's point of view as this one has been. This note should not be included in the financial statements.

b. If the auditor can form an opinion as to the ending inventory by means of procedures which include observation of the physical inventory, he may satisfy himself as to the prior period by means of other procedures. These might include tests of prior transactions, reviews of the records of prior counts and the application of gross profit tests. If he is satisfied by these other procedures, he is not required to comment in his report, but he may disclose the circumstances if he wishes and describe the other procedures. It is unlikely that disclosure of other satisfactory procedures has significance to the reader, and there is a possibility that the disclosure may be misinterpreted to be a qualification of the auditor's opinion.

Note 2

a. If the auditor agrees that the effects of the accounting change from Fifo to Lifo were immaterial, the proposed note is adequate. If the effects of the change were material, the amounts of the effects should be shown.

b. Both Fifo and Lifo are generally accepted accounting principles. If the auditor considers the effects of the change to be material, he should take exception in his report to the consistency of application of generally accepted accounting principles. He may refer to the note for disclosure of the effects of the change and may also indicate his approval of the change if he wishes. If the effects are immaterial, footnote disclosure is adequate and the change need not be mentioned in the auditor's report.

Note 3

a. Recognition of appraised values is not a generally accepted accounting principle. Generally the auditor should recommend reversal of the entry recording the anticipated gain on the sale. Footnote disclosure of the appraised value and the intention to sell may be desirable.

If, under the circumstances, the auditor believes that there is substantial authoritative support for this treatment, it may be allowed to stand. In that unlikely event, he would recommend that a note describe the principle and the amounts involved and disclose that this treatment is at variance with some authoritative sources (such as Opinion No. 6 of the Accounting Principles Board).

b. If the appraisal entry is reversed and adequate footnote disclosure of the appraisal and intended sale is given, no disclosure in the report or modification of the opinion is necessary. If the auditor should conclude that recording the appraisal has substantial authoritative support, he might render an unqualified opinion but disclose in a middle paragraph the principle and the amounts involved and that the principle used is at variance with some authoritative sources; in this case disclosure in the auditor's report would be an alternative to disclosure in a note. The auditor assumes an extra burden in justifying a departure from the treatment described in primary sources of substantial authoritative support.

Note 4

a. The small relative size of the common stock distribution (less than the 20% to 25% recommended in Accounting Research Bulletin 43) and its characterization as a dividend in notices to stockholders indicate that it should have been recorded as a stock dividend, not a stock split-up. The fair value of the new stock issued (based on current market price) should have been transferred from the retained earnings account to common stock—stated value and common stock—excess over stated value. If legally possible, an appropriate adjustment should now be made.

b. Assuming the suggested adjusting entry is made, no disclosure in the auditor's report or opinion modification is necessary.

Note 5

a. The extent of disclosure in the pension plan note is inadequate in that it does not include the following:
   1. A description of the employee groups covered by the pension plan.
   2. A more exact statement of the Company's accounting and funding policies for the pension plan.
   3. The excess, if any, of the actuarially computed value of vested benefits over the total of the pension fund and any balance sheet pension accruals.

   These disclosures should be made in the note.

b. The change in the method of accounting for the pension plan necessitates a qualification of the auditor's opinion relating to the consistency of application of generally accepted accounting principles. Inasmuch as the change was from a principle lacking general acceptance to one with general acceptance, the auditor should indicate his approval of the change. The auditor may refer to the note for a detailed description of the change and its effects.

Answer 5

a. Audit working papers are a key tool in fulfilling the first standard of field work, which requires that the work be adequately planned and that assistants be properly supervised. Preparation of working papers avoids duplication of effort and enables the individual auditor and auditor-in-charge to determine what has been done. This is particularly important since work may be done over an extended period and by more than one person. Signing and dating the working paper evidences that the work was performed by a person with adequate training on a timely basis.

   The working paper review helps supervisors to assess the quality of work done and the competence of their subordinates. Evidence that there has been adequate supervision and review is provided by having reviewers initial working papers and prepare review sheets for clearance by the staff and inclusion in the files.

   The use of prior years' working papers helps auditors on succeeding engagements to learn company procedures and decide what auditing procedures to follow. They must, of course, exercise caution; prior years' procedures should not be applied unimaginatively or without investigating their present applicability in terms of materiality and internal control.

   Working papers should also show evidence of compliance with the second standard of field work, which calls for a proper study and evaluation of internal control and for determination of the extent of audit tests based upon this review. As noted above, it is important that there be an annual review of internal control. Evidence of this review should be included in the current or permanent working paper files, and memorandums should be updated. When there are changes in internal control, a conclusion should be made as to the effect upon the audit scope.

The third standard of field work requires the auditor to obtain sufficient competent evidential matter to support his opinion regarding financial statements. Working papers provide support for the auditor's opinion and the financial statements to which it applies and constitute evidence that an adequate examination has been performed. This is accomplished by showing on the working paper, usually by means of tick marks, the source documents examined and other auditing procedures followed.

An auditor might be able to satisfy himself for the current period's financial statements without preparing formal working papers, but he later would be unable to substantiate his conclusions or the competence of his examination to those who might question his judgment. He could no longer rely on his memory for the work that he did or the reasoning he followed. Lack of documentation would be inconvenient at best and could become crucial several years later if the auditor were to be involved in litigation regarding the financial affairs of his client or the quality of his examination. Even though an examination is completely performed by a sole practitioner or the partner responsible for the opinion, preparation of complete working papers is essential to provide evidence of the quality of the examination performed.

b. The working paper should include the following:

1. A title including the client's name, the date of the examination and the name of the working paper.
2. The name of the auditor performing the work and the date.
3. A logical index (in accord with the standard working paper indexing system, if any).
4. An indication that appropriate cross-references to the audit program and other working papers have been made.
5. An indication that the account analysis was prepared by the client.
6. The source of the information included in the working paper.
7. An indication, usually by tick marks, of what examination of source documents and other auditing procedures were performed. Unless a standard system is being used, all tick marks should be explained on the working paper. Precise terminology should be used; general terms such as "vouched" or "verified" should be replaced by more exact descriptions of the supporting documents examined or other verification made.
8. Commentary (or references to commentary on point sheets or memorandums) regarding exceptions encountered and questions raised by the examination. When a point is raised, it is important that its disposition also be shown in the working papers.
9. Suggested adjustments or adjusting entries, together with an indication of their disposition.
10. Comments and recommendations for improvements in internal control and the client's procedures. These will provide a basis for the auditor's letter of recommendations to the client.
11. A conclusion on the work done (unless the conclusion is made in the audit program or a memorandum).

Answer 6

a. Documentation is essential to consistent operations, particularly during personnel changes. Systems analysts and/or programmers should prepare a description of the interrelationship among computer runs and a run manual for each individual run. The run manual should include:

1. The definition of the problem which this particular run solves.
2. A description of how the run fits into the overall system.
3. A program description (including flowcharts and a program listing).
4. Instructions for the computer operator.
5. A listing of controls associated with the run.
6. A record of tests of the run, approvals and modifications of the program.

If the EDP department is large enough, systems design should be separated from programming. Both these functions should be separated from operation of the EDP equipment.

Unauthorized changes in the program must be prevented. A procedure for documentation and approval of changes should be instituted.

b. Program testing procedures ("debugging") should be applied before a program is used. These procedures should include processing with test data which is designed to violate system controls and with actual transaction data as a check on the comprehensiveness of the test data. The entire system, from input through processing to reporting, should be tested, and data should be tested on successive cycles to verify updating capabilities.

c. Manipulations involving EDP require both knowledge of the programs and access to the computer. In view of this:

1. Only employees involved in operation of the equipment should be admitted to the computer room.
2. Computer operations should be scheduled and an operations log maintained.
3. Computer operators should receive copies of operating instructions but not have access to run manuals.

General protective safeguards include environmental control, security precautions, fire protection and appropriate insurance.

d.
1. Movement of data within the EDP department should be controlled; one or more persons within the department should be designated as control clerk(s).
2. The operating function should be divided to provide for a librarian's custody of data files and records when not in use.
3. Backup files and documentation should be stored in a separate area.
4. Procedural controls should be instituted to minimize the possibility of data or program file destruction through operator error; these controls should include the identification of files through external labels, prevention of unwanted tape erasures by use of file protection rings, tape library procedures, and the use of header labels and boundary protection.

Answer 7

a. The CPA must decide whether the principle has found general acceptance. This determination requires exercise of judgment, familiarity with alternative principles which may be applicable to the transactions or facts under consideration and recognition that an accounting principle may have only limited usage but still have general acceptance.

The CPA must satisfy himself that the principles employed will result in a fair presentation of financial position and the results of operations. Use of principles which appear to have substantial authoritative support may be misleading because the principle has limited use or circumstances differ. Should the opinion be questioned, a narrow technical defense might not be adequate.

In consulting authoritative sources, the CPA must differentiate between descriptions of practice as it exists and prescriptive proposals for changes in principles which have not yet gained general acceptance. He also must be sure that his source is current, that the pronouncement relied upon has not been amended and that the practices described still are being widely used. When a CPA accepts accounting treatments which depart from authoritative sources, he assumes the additional burden of justifying their general acceptability.

In summary, the CPA in forming an opinion as to the general acceptability of an accounting principle should

1. Determine the circumstances surrounding the transaction or condition being reported upon.
2. Determine the alternative treatments available and the degree of support for each by surveying relevant literature and present practices.
3. Judge the applicability of the alternative treatments in terms of the particular circumstances.

b. Primary sources of support include Opinions of the Accounting Principles Board, Accounting Research Bulletins of the Committee on Accounting Procedures, AICPA industry audit guides, and the SEC's Regulation S-X and accounting series releases. Where authoritative support is not available in any of these sources, predominant practice within an industry or of business enterprises in general constitutes the most authoritative support.

c. Secondary sources of substantial authoritative support include:

1. Pronouncements of industry regulatory authorities.
2. Substantial practice within an industry or business enterprises in general. Evidence may be provided by published financial reports or summaries such as *Accounting Trends and Techniques.*
3. Accounting research studies of the AICPA.
4. Published research studies of authoritative professional societies.
5. Federal, state and local laws and court decisions.
6. Accounting textbooks and respected reference books.
7. Publications of recognized industry associations.
8. Published articles and speeches of distinguished individuals.

BUSINESS LAW
(Commercial Law)

May 7, 1971; 8:30 a.m. to 12:00 m.

Answer 1

1. True	11. False	21. False
2. False	12. True	22. True
3. True	13. False	23. True
4. False	14. False	24. True
5. False	15. True	25. True
6. False	16. False	26. False
7. True	17. False	27. False
8. True	18. False	28. True
9. False	19. False	29. True
10. True	20. True	30. True

Answer 2

31. False	41. False	51. False
32. False	42. False	52. True
33. False	43. False	53. True
34. False	44. False	54. False
35. True	45. True	55. False
36. False	46. True	56. True
37. True	47. True	57. False
38. True	48. False	58. True
39. False	49. False	59. False
40. True	50. True	60. False

Answer 3

61. False	71. True	81. True
62. False	72. False	82. False
63. False	73. True	83. False
64. False	74. True	84. False
65. True	75. False	85. False
66. True	76. True	86. True
67. False	77. True	87. True
68. True	78. False	88. False
69. True	79. True	89. True
70. True	80. False	90. True

Answer 4

a. 1. The first basis for liability would be negligence, because Wilson and Wyatt failed to exercise reasonable care in the conduct of their examination. The failure to meet the standards of the profession would be indicative of negligence. The main problem regarding recovery for negligence is that Risk Capital is not in privity of contract with Wilson and Wyatt.

The second basis of liability relates to enforcement of contract and negligence. Under this approach, Risk Capital will claim that it should be able to enforce the contract because it was a third party beneficiary of the agreement between Wilson and Wyatt and Florida Sunshine. If it can be shown that Wilson and Wyatt knew of Risk Capital's demand for the audited financial statements and that the primary purpose of their preparation was to protect Risk Capital, a third party beneficiary relationship clearly existed.

The third basis for liability is fraud. Here Risk Capital must show that the accountants either knew the financial statements were incorrect or prepared them without regard for due professional care; that is, that their negligence was so great (i.e., gross negligence) as to constitute constructive fraud. If fraud is proven, lack of privity is not a barrier to Risk Capital's recovery.

2. No. If only ordinary negligence is proven, then recovery by a third party such as Risk Capital will be denied because of lack of privity. Consequently, in order to prevail, Risk Capital must establish either a third party beneficiary relationship or fraud.

b. 1. Yes. Wells and White were within their rights to refuse Strong's demands. It is the independent accountant and not the client who determines whether the client's financial statements are presented in accordance with generally accepted accounting principles. In fact, Strong's action on behalf of Allie Corporation probably would constitute a breach of contract. Therefore, Wells and White are entitled to recover the $1,750 for services rendered up to the date of dismissal.

2. No. The audit working papers, files and duplicate tax returns belong to the accountant. The CPA is an independent contractor and cannot be compelled to surrender such papers. As to the next problem indicated, these papers may be vital to establishing innocence if the client should later bring legal action against the CPA for negligence.

c. No. The normal audit function is not designed primarily to discover defalcations. The accountant will be liable only if negligence in the audit function resulted in the failure to detect defalcations. The fact that the new accountant failed to discover the defalcation in the first audit, that the amount was immaterial and that the defalcation was not discovered without several months of special study indicates that Wells and White were not negligent.

Answer 5

Transaction 1

The Corporation is liable. An oral contract for the sale of goods for a price of less than $500 is enforceable because the contract is not subject to the Statute of Frauds.

Transaction 2

The Corporation is liable for payment of the purchase price of five dozen dresses. Although a contract for the sale of goods for the price of $500 or more is not enforceable unless there is sufficient writing to indicate that a contract for sale has been made between the parties and signed by the party against whom enforcement is sought, the oral contract here is enforceable for the goods which have been received and accepted. However, the oral contract is not enforceable for the remaining five dozen dresses which the Corporation has neither received, accepted nor paid for.

Transaction 3

The Corporation may reject the goods. Any sample or model which is made a part of the basis of the bargain creates an express warranty that the whole of the goods shall conform to the sample or model. Moreover, any description of the goods which is made a part of the basis of the bargain creates an express warranty that the goods shall conform to the description. If the goods fail in any respect to conform to the contract, the company may reject the whole, accept the whole, or accept any commercial unit or units and reject the rest. Here the Corporation lawfully may reject the goods because of breach of express warranty and timely rejection.

Transaction 4

The Corporation is liable for $6,000. The agreement which modified the original written contract needs no consideration to be binding. However, the Statute of Frauds must be complied with if the contract as modified is to be within its provisions. Although the oral modification agreement related to a contract for the sale of goods for the price of $500 or more, the oral contract satisfied the Statute of Frauds because the company received and accepted the goods, and thus the oral contract is enforceable with respect to such goods.

Answer 6

a. Yes. The Statute of Frauds does not render the contract unenforceable.

The contract is subject to the requirements of the Statute of Frauds because it involves the sale of goods with a price of $500 or more. Prior to the Uniform Commercial Code, the Statute of Frauds would have been a bar to enforcement, because the party to be charged (i.e., the defendant) did not sign a memorandum of the agreement. However, the Code has modified this rule by providing that between merchants a memorandum signed by either party will bind both parties (1) if it is sufficient to bind the signer and is sent to the other party within a reasonable time after the oral agreement was made and (2) if no written objection is given by the other party within ten days after receipt.

The fact that the total price and delivery terms were erroneously omitted does not prevent enforcement. The Code provides that a memorandum will not fail to satisfy the Statute so long as it contains the stated quantity involved.

b. 1. The question is whether a valid accord and satisfaction has taken place.

Without express consent in writing, the payment of a lesser sum of money in satisfaction of a liquidated (undisputed) claim normally is invalid due to a lack of consideration. But where there is a bona fide dispute as to the amount owing or the method of settling the account (as in this case), the courts have held that the cashing of the check tendered as payment-in-full amounts to an accord and satisfaction.

Mercury's attempt to cash the check and disclaim the credit for the returned books is without legal basis. In order to retain its rights under the original contract it should not have cashed the check.

Whether it is the general custom of the industry to accept the returned books would then be decided in a court of law. Since there was a bona fide dispute and since the check was cashed, Mercury, in effect, accepted the settlement tendered by Famous.

2. No. Mercury will not be able to collect anything further because the account receivable is invalid. Inventory should be debited to the extent of the cost of the returned books.

Answer 7

a. 1. The first defense of no consideration is invalid. Ordinarily there must be consideration for the promise of the surety. However, if the suretyship undertaking is entered into before or at the time the principal obligation arises, a separate consideration is not required.

2. The second defense that there was no notice of default is invalid. To establish the surety's liability, the creditor need not give notice of default to the surety unless he is expressly required to do so by the contract.

3. The third defense that the maximum liability, if any, is $25,000 also is invalid. If there is no express agreement to the contrary and if there are two or more sureties, each is liable to the creditor for the full amount of the debt until the creditor has been paid in full.

b. Finest Fashions may recover $25,000 from Grand Gowns. As between sureties, each is liable only for a proportionate share of the debt. Therefore, since the Company paid more than its share, it is entitled to demand that its co-surety contribute one-half the amount or $25,000 in the absence of a contrary agreement between the co-sureties.

c. Finest Fashions may sue the debtor for $50,000. When a surety pays the debt which he is obligated to pay, he is subrogated to the claim and to the right of the creditor. The Company is entitled to indemnity from the debtor for the amount it paid.

d. Since the extension of time to pay is a material modification of the original purchase order and was granted without Finest Fashions' consent, its liability will be discharged.

Answer 8

a.
1. Yes. Prince Realty is liable to Trinity Plumbing. Although Baker is an infant by law in almost every state, he may act lawfully as an agent if he possesses sufficient mental capacity, judgment or business acumen to exercise the authority conferred upon him. Here Baker had no express authority to enter into the contract with Trinity. However, because he has authority to act as the managing agent, he has the apparent authority to make such a contract. Since the principal was responsible for the misleading appearance of authority and Trinity acted in good faith without knowledge of the secret instruction, Prince is estopped from denying the existence of such authority.
2. Yes. Prince Realty is liable to Corbin. A principal is liable for the tortious acts committed by his agent within the scope of his employment. Here the agent was acting on behalf of the principal and not for his own benefit.
3. No. Prince Realty may not collect the fourth month's rent from the tenants. Payment to the agent is deemed payment to the principal when the principal did not communicate to the tenants that Baker's authority had been revoked. A third person who has previously dealt with the agent and who now deals with him without knowledge of the revocation of his authority, may enforce the transaction against the principal. While Baker had no actual authority to collect the fourth month's rent he continued to have apparent authority after termination of the agency.

b.
1. a. The first defense is not valid. Under the law of agency the undisclosed principal is held liable as though he were a party to the contract, provided the agent, in negotiating the transaction, intends to act for the undisclosed principal and has acted within the scope of his powers. The liability of the undisclosed principal is imposed upon him by operation of law.

   b. The second defense is not valid. If the third person discovers that an agency exists and learns the identity of the principal, he has the right to recognize the agency and hold the principal liable or to pursue his rights on the contract against the agent.

2. Lemmon is liable to Ladd on the contract. In the case of an undisclosed principal the agent is the contracting party and is liable on the contract. After Ladd discovers the existence of the agency and learns the identity of the principal, he may elect to sue either the principal or the agent. He must make an election to hold either the principal or the agent liable; he cannot hold both. The undisclosed principal and the agent are neither joint nor joint and several promissors under the majority rule.

ACCOUNTING THEORY
(Theory of Accounts)
May 7, 1971; 1:30 to 5:00 p.m.

Answer 1

1. c	11. b
2. a	12. c
3. b	13. b
4. d	14. a
5. d	15. d
6. c	16. c
7. c	17. b
8. c	18. a
9. c	19. d
10. d	20. a

Answer 2

21. d	31. a
22. a	32. a
23. b	33. b
24. b	34. d
25. c	35. c
26. d	36. b
27. c	37. d
28. c	38. b
29. d	39. b
30. a	40. c

Answer 3

a. 1. This is a common balance sheet presentation and has the advantage of being familiar to users of financial statements. The face or maturity value of $1,000,000 is shown in an obvious manner. The total of $1,106,775 is the objectively determined exchange price at which the bonds were issued; it represents the cost to the Guadagno Corporation and the fair market value of the bond obligations given. Thus, this is in keeping with the generally accepted accounting practice of using exchange prices as a primary source of data.

2. This presentation indicates the dual nature of the bond obligations. There is an obligation to make periodic payments of $40,000 and an obligation to pay the $1,000,000 at maturity. The amounts presented on the balance sheet are the present values of each of the future obligations discounted at the initial effective rate of interest.

   A proper emphasis is placed upon the accrual concept; that is, that interest accrues through the passage of time. The emphasis upon premiums and discounts is eliminated.
3. This presentation shows the total liability which is incurred in a bond issue, but it ignores the time value of money. This would be a fair presentation of the bond obligations only if the effective interest rate were zero.

b. When an entity issues interest-bearing bonds, it normally accepts two types of obligations: (1) to pay interest at regular intervals and (2) to pay the principal at maturity. The investors who purchase the Guadagno Corporation bonds expect to receive $40,000 each January 1 and July 1 through January 1, 1991 plus $1,000,000 principal on January 1, 1991. Since this ($40,000) is more than the 7% per annum ($35,000 semiannually) that the investors would be willing to accept on an investment of $1,000,000 in these bonds, they are willing to bid up the price—to pay a premium for them. The amount that the investors should be willing to pay for these future cash flows depends upon the interest rate that they are willing to accept on their investment(s) in this security.

The amount that the investors are willing to pay (and the issuer is willing to accept), $1,106,775, is the present value of the future cash flows discounted at the rate of interest that they will accept.

Another way of viewing this is that the $1,106,775 is the amount which, if invested at an annual interest rate of 7% compounded semiannually, would allow withdrawals of $40,000 every six months from July 1, 1971 through January 1, 1991 and $1,000,000 on January 1, 1991.

Even when bonds are issued at their maturity value, the price paid coincides with the maturity value because the coupon rate is equal to the effective rate. If the bonds had been issued at their maturity value, the $1,000,000 would be the present value of future interest and principal payments discounted at an annual rate of 8% compounded semiannually.

Here the effective rate of interest is less than the coupon rate, so the price of the bonds is greater than the maturity value. If the effective rate of interest were greater than the coupon rate, the bonds would sell for less than the maturity value.

c. 1. The use of the coupon rate for discounting bond obligations would give the face value of the bond at January 1, 1971 and at any interest-payment date thereafter. Although the coupon rate is readily available while the effective rate must be computed, the coupon rate may be set arbitrarily at the discretion of management so that there would be little or no support for accepting it as the appropriate discount rate.
2. The effective interest rate at January 1, 1971 is the market rate to the Guadagno Corporation for long-term borrowing. This rate gives a dis-

counted value for the bond obligations which is the amount that could be invested at January 1, 1971 at the market rate of interest. This investment would provide the sums needed to pay the recurring interest obligation plus the principal at maturity. Thus, the effective interest rate is objectively determined and verifiable.

d. The market or yield rate of interest at the date of issue should be used throughout the life of the bond because it reflects the interest obligation which the issuer accepted at the time of issue. The resulting value at the date of issue was the current value at that time and is similar to historical cost. Also, this yield rate is objectively determined in an exchange transaction.

The continued use of the issue-date yield rate results in a failure to reflect whether the burden is too high or too low in terms of the changes which may have taken place in the interest rate. Using a current yield rate produces a current value, that is, the amount which could currently be invested to produce the desired payments. When the current yield rate is lower than at the issue date (or than at the previous valuation date), the liabilities for principal and interest would increase. When the current yield rate is higher than at the issue date (or at the previous valuation date), the liabilities would decrease. Thus, holding gains and losses could be determined. If the debt is held until maturity, the total of the interest expense and the holding gains and losses under this method would equal the total interest expense using the yield rate at issue date.

Answer 4

Statement 1

a. Erroneous conclusion: That the primary accounting function is to provide financial information to management.

b. Accounting is a service activity which provides quantitative financial information for making economic decisions. One area of accounting, called managerial accounting, is concerned primarily with providing quantitative information to management. Another area, often called financial accounting, is concerned primarily with providing to external users a continual financial history of economic resources and obligations of an individual business enterprise and of the economic activities that change those resources and obligations. These data are intended to aid the decision making of external users.

Auditing or the attest function, often considered to be a part of accounting, is concerned primarily with providing an opinion by an independent expert that a communication of economic data by one party to another is fairly presented.

Statement 2

a. Fallacy: That financial statements prepared with due regard for the conservatism convention can be free from bias with respect to continuing, prospective and retiring stockholders.

Half-truth: That financial statements can be free from bias, even if the conservatism convention is not applied, except, possibly with respect to the outlook of the processor or preparer of the data.

b. The conventional definition of conservatism, "to anticipate all possible losses but no possible gains," tends to result in the reported earnings and net assets of an enterprise being less than they otherwise might be (e.g., using the lower of cost or market approach for inventories, or recognizing revenue on a completed contract basis where the percentage of completion method would be more appropriate). Thus, to the extent (1) that reported earnings are reduced thereby and (2) that reported earnings affect the price of a share of the stock of an enterprise, the market price per share will be less, and the retiring stockholders may be encouraged to (a) sell rather than hold their shares and (b) sell at a price that is less than would otherwise be the case.

Freedom from bias is often advanced as a desirable standard or ideal for accounting information; this probably is unattaniable with respect to general purpose financial statements because of the conflicting interests among the many users of the statements (e.g., management versus owners or owners versus employees and creditors).

It often appears that many accountants relate the freedom from bias concept to the attitude of the accountant or auditor and the closely related concept of independence. But the freedom from bias concept is concerned primarily with the ability of the measurement method to portray accurately the activity being measured. Thus the accountant may be completely independent in attitude, yet, by his choice of measurement methods, he may introduce bias into the accounting information.

Statement 3

a. Inconsistency: The term "reserve" is inconsistent with generally accepted accounting terminology.

Fallacy or half-truth: That a firm would have any formally established Lifo "reserves."

Fallacy or half-truth: That a formally established Lifo "reserve" could affect the income tax charge (per books).

b. The generally accepted meaning of the term "reserve" should restrict its usage to appropriations of retained earnings. Such appropriations should not affect the income statement and thus should not be involved in the situation described in Statement 3.

Two types of "reserves" might possibly be established and combined with the Lifo method for financial reporting purposes. The first of these, the Allowance to Reduce Inventory to the Lower of Lifo Cost or Market (a contra asset), is rarely used in practice, is not acceptable for federal income tax reporting and is not likely to even be appropriate when prices of inventory items are rising as is suggested here. The second "reserve," the Excess of Replacement Cost over Lifo Cost of Basic Inventory Temporarily Liquidated (a current liability), normally is not acceptable for federal income tax reporting and generally is not considered to be an acceptable accounting practice in the United States because the procedure has the effect (at least partially) of converting Lifo to the base-stock method.

Since neither of these "reserves" is acceptable for tax reporting purposes, writing them off in connection with the change from Lifo to Fifo could not affect taxable income or the amount of income tax currently payable. Thus the only way that the statement could be true would be for the firm to have combined the use of one or both of the "reserves" with income tax allocation for the temporary differences between reported and taxable income. Without income tax allocation, the elimination of any Lifo "reserves" could not increase both the income tax charge and income after taxes (as reported on the income statement) because the income tax charge would equal the income tax currently payable. Since the combination of rarely used "reserves" with income tax allocation procedures is highly unlikely, it would be appropriate to call the statement a half-truth.

Since it is highly unlikely that the firm would have any formally established Lifo "reserves," the most likely explanation of this difference is that the Fifo cost is higher than the Lifo cost of the inventory at the end of the period. Such a difference is sometimes referred to as a secret or hidden "reserve."

Statement 4

a. Fallacy, half-truth or erroneous comment: That the net receipts of a firm result only from its tangible and intangible assets.

Fallacy or half-truth: That the total of the individual discounted present values will be less than the total discounted present value of the firm as a whole.

b. The net receipts of a firm result from the contributions of a great variety of inputs. Some of these inputs are treated as assets, many (e.g., the efforts of salesmen) are not. These nonasset inputs predominate in firms that only provide services, but also may predominate in many firms that deal in products.

The marginal expected net receipts (or marginal contributions) of an input are composed of two elements: (1) the separate effects of that input upon net receipts and (2) the interaction effect on net receipts of that input with all the other inputs to the firm.

For most nonmonetary inputs to business enterprises the major portion of the marginal contribution will be positive interaction effects. Thus the total of the marginal contributions of more than one input will include much double counting.

For example, assume that a firm has only two inputs, A and B, and that there are ten units of each; the relationship between these inputs and the firm's net receipts, R, will be:

$$R = A + AB + B$$

Taking partial derivatives, the marginal contributions are:

$$A = 1 + B$$
$$B = A + 1$$

At the required input levels the total marginal contributions will be:

$$10\ (1 + 10) + 10\ (10 + 1) = 220$$

Yet the total receipts of the entire firm will be only:

$$10 + (10 \times 10) + 10 = 120$$

The discrepancy of $220 - 120 = 100$ results from double counting the interaction effect:

$$AB = 10 \times 10 = 100$$

With a realistically large number of inputs, the cumulative impact of such double counting will be enormous.

This double counting does not occur when one calculates the marginal contributions of the firm as a whole. Therefore, the total of the discounted present values of the contributions of individual inputs will exceed the total discounted present value of the firm as a whole. This excess is the total of the discounted present value of all double-counted interaction effects whenever all inputs to the firm are assets.

To the extent that some inputs are not treated as assets, the gap between the total present values for the individual assets and for the firm as a whole will narrow.

Only in extreme cases where firms have receipts but essentially no assets could the discounted present value for the firm as a whole exceed that of the total for the individual assets.

For the unlikely case of a single input firm, the marginal contribution would equal the total net receipts and both methods would yield the same valuation, thus also making the statement fallacious.

Answer 5

a. 1. Accounting for an intangible asset involves the same kinds of problems as accounting for plant assets, namely, determining an initial carrying amount, accounting for that amount after acquisition under normal business conditions (amortization) and accounting for that amount if the value declines substantially and permanently.

Generally in historical-cost based accounting, plant and intangible assets are measured initially by their acquisition price (historical cost). Typically a firm gains possession of an asset by making expenditures that are expected to increase revenue or reduce costs to be incurred in future periods. If the future benefit or the period to be benefited is questionable, the expenditure usually is treated as a current expense and not as a deferred cost. Associating costs with the revenue or the period to which they are expected to relate is a basic problem in historical-cost based accounting both in measuring periodic income and in accounting for assets. The basic accounting treatment does not depend upon whether the asset is a building, a piece of equipment, an element of inventory, a prepaid insurance premium or whether it is tangible or intangible. The cost of goodwill and similar intangible assets is therefore essentially the same as the cost of land, buildings or equipment under historical-cost based accounting. Conceptually all historical costs are measures of future service potential.

2. The problems differ and are complicated by the characteristics of an intangible asset: its lack of physical qualities makes evidence of its existence elusive, its value is often difficult to estimate and its useful life may be indeterminable.

Accounting for the cost of a plant asset after acquisition normally depends upon its estimated life. The cost of assets with perpetual existence, such as land, is carried forward as an asset without amortization, and the cost of assets with limited lives is amortized by systematic charges to expense. Goodwill and similar intangible assets do not clearly fit either classification since their lives are neither infinite nor specifically limited, but are indeterminate.

Any amortization of acquired goodwill is not deductible in computing income taxes payable. Thus goodwill is different from plant assets in that the benefits of tax reduction do not accrue to the enterprise even though it has taxable income that is equal to or greater than the amount of goodwill to be amortized.

b. 1. Costs of intangible assets which have fixed or reasonably determinable useful lives are now amortized by systematic charges to expense during those periods. Differences of opinion center upon the amortization of acquired intangible assets with lives which cannot be estimated reliably either at the date of acquisition or perhaps long after (for example, goodwill and trade names).

The literature on business combinations and goodwill contains at least four possible accounting treatments of goodwill and similar intangible assets:

a. Retain the cost as an asset indefinitely unless a reduction in its value becomes evident.
b. Retain the cost as an asset but permit amortization as an operating expense over an arbitrary period.
c. Retain the cost as an asset but require amortization as an operating expense over its estimated limited life or over an arbitrary but specified maximum and minimum period.
d. Deduct the cost from stockholders' equity at the date acquired.

Two of the four accounting proposals which do not involve amortization of goodwill as an operating expense are based largely upon the contention that goodwill is not a producing asset, so that goodwill amortization would conceal the superior earnings that supposedly were purchased. It also is contended that goodwill value is not consumed or used to produce earnings in the same manner as various property rights are used, and therefore net income should not be reduced by amortization of goodwill. Further, net income should not be reduced by both amortization of goodwill and the current expenditures that are incurred to enhance or maintain the value of the acquired intangible assets. All methods of amortizing goodwill are criticized as arbitrary because the life of goodwill is indefinite and an estimated period of existence is not measurable.

The basis for proposing that the cost of goodwill be retained as an asset until a loss in value becomes evident is that the cost incurred for acquired goodwill should be accounted for as an asset at the date acquired and in later periods. The cost should not be reduced as long as the value of the asset is at least equal to that cost.

The basis for proposing that the cost of goodwill be deducted from stockholders' equity at the date acquired is that the nature of goodwill differs from other assets and warrants special accounting treatment. Since goodwill attaches only to a business as a whole and its value fluctuates widely for innumerable reasons, estimates of either the terms of existence or current value are unreliable for purposes of income determination. Deducting the cost of an asset from stockholders' equity (either retained earnings or capital in excess of par or stated value) at the date incurred does not match costs with revenue.

Amortizing the cost of goodwill and similar intangible assets on arbitrary bases in the absence of evidence of limited lives or decreased values may recognize expenses and decreases of assets prematurely, but delaying amortization of the cost until a loss is evident may recognize the decreases after the fact.

A solution is to set minimum and maximum amortization periods. This accounting follows from the observation that few, if any, intangible assets last forever, although some may seem to last almost indefinitely. Allocating the cost of goodwill or other intangible assets with an indeterminate life over time is necessary because the value almost inevitably becomes zero at some future date. Since that date is indeterminate, the end of the useful life must necessarily be set arbitrarily at some point or within some reasonable range of time for accounting purposes.

b. 2. If the value of an intangible asset will disappear eventually, it follows that the recorded cost of that intangible asset should be amortized by systematic charges to expenses over the periods estimated to be benefited. All relevant factors should be considered in estimating the useful lives of intangible assets. The period of amortization of intangible assets should be determined from the pertinent factors.

The cost of each type of intangible asset should be amortized on the basis of the estimated life of that specific asset and should not be written off in the period of acquisition. Analysis of all factors should result in a reasonable estimate of the useful life of most intangible assets. A reasonable estimate of the useful life may often be based on upper and lower limits even though a fixed existence is not determinable.

The period of amortization should not, however, exceed 40 years. Analysis at the time of acquisition may indicate that the indeterminate lives of some intangible assets are likely to exceed 40 years and the cost of those assets should be amortized over the maximum period of 40 years, not an arbitrary shorter period.

The straight-line method of amortization—equal annual amounts—should be applied unless a company demonstrates that another systematic method is more appropriate.

A company should evaluate the periods of amortization continually to determine whether later events and circumstances warrant revised estimates of useful lives. If estimates are changed, the unamortized cost should be allocated to the increased or reduced number of remaining periods in the revised useful life but not to exceed 40 years after acquisition. Estimation of value and future benefits of an intangible asset may indicate that the unamortized cost should be reduced significantly by a charge to expense. But a single loss year or even a few loss years together do not necessarily justify an extraordinary charge to expense for all or a large part of the unamortized cost of intangible assets.

Ordinarily, goodwill and similar intangible assets cannot be disposed of apart from the enterprise as a whole. But a large segment or separable group of assets of an acquired company or the entire acquired company may be sold or otherwise liquidated, and all or a portion of the unamortized cost of the goodwill recognized in the acquisition should be included in the cost of the assets sold.

Answer 6

a. One of the principal advantages to the client of participation in the credit card plan is the great increase in the number of potential customers who have preestablished credit. This factor is particularly important in view of the presence of the large military base. Service personnel attached to such a base tend to be somewhat transient; they spend a relatively short time in each community and are more likely to buy on credit at places where their credit is already established (such as at stores which participate in a national credit card plan). The need to conduct credit investigations for such personnel (which may be slow and costly in view of their mobility) is eliminated if they are credit card holders.

There is a related advantage for the client in respect to other potential customers who expect to be more permanent in the community. Again, if they hold cards obtained in other cities, their credit is preestablished and the expense and effort of investigating their credit standing is eliminated.

With respect to transient, new, and long-time residents who use credit cards, there will be less bookkeeping effort in connection with accounts receivable, fewer credit losses and speedier realization on receivables since the client will receive an immediate credit to its bank balance for all presented credit card charges that are properly executed.

There are a number of disadvantages to affiliating with the credit card plan. One of the major ones is the immediate loss of 3.5% on short-term accounts and approximately 18% on long-term receivables for all sales where credit cards are used. It is likely that some of the client's customers who have been receiving credit from the store on the old basis will now charge their purchases by means of the credit cards. This would mean, of course, that the bank and credit card franchiser would receive a portion of the money that formerly would have gone to the client.

The client will not be able to eliminate the credit department, the accounts receivable records, or billing of customers since credit arrangements which have already been established are to be continued and operated parallel with the credit card plan. Costs of these elements would not drop in proportion to the shift from usage of the old credit arrangements to usage of the credit cards. Credit losses may, in fact, increase relatively if the client's credit policies were more lenient than those for the card plan, because many of those who charge at the store will continue to do so even though they did not meet the minimum standard for getting a credit card. Thus the store's remaining credit customers may become the more risky portion from which higher overall losses can be expected. The client may also incur some losses if its clerical help do not refuse to accept expired cards or cards that have been reported stolen or canceled.

It is possible that some potential new credit customers will assume that they can only have credit at the store through the medium of the credit cards and because they do not have them will not apply for conventional credit which is still available. If this happens along with the closing of the old accounts, the client eventually will have few charge customers.

b. After the credit card plan becomes fully operative, the differences in the balances of certain accounts will depend in part upon the extent to which usage of credit cards supplants usage of the old credit plan. It also depends upon whether affiliation with the credit card plan simply means an increase in credit business, with essential continuation of the volume of business done on the conventional credit basis. The balances of the following accounts have the potential to change materially:
   1. Receivables from customers. If the total volume of credit business remains about the same and there is a shift to usage of the credit cards, the balance would tend to decline.
   2. Allowance for doubtful accounts. The balance of this account may decline absolutely but increase relatively as the accounts receivable balance declines.
   3. The expense or contra-revenue account to which the 3.5% discount is charged will increase from zero after the credit card plan becomes effective.
   4. Expense accounts for the costs of operating the credit department, the receivables ledger and billing department would decrease if the total volume of credit business remains about the same and any substantial portion of the credit is extended by means of the credit cards. As noted above, the change would not necessarily be proportional to the shift.
   5. The balance of the revenue account which reflects interest earned on long-term receivables would decline if there is much utilization of the credit cards unless, of course, the credit card volume was simply additional business.
   6. Bad debt expense might change. Remarks made under items 1 and 2 above are applicable here.
   7. If in fact the card plan results in increased volume, the sales revenue, cost of goods sold and other expenses which vary with volume obviously will increase.

Answer 7

a. In federal income tax accounting the doctrine of constructive receipt is applied when a cash-basis taxpayer is entitled to and could collect the cash but does not receive it, due entirely to his own actions. Such cash is deemed to be income at the time it becomes unconditionally available and subject to the taxpayer's demand regardless of whether it has legally been accepted.

The mere promise or obligation to pay is insufficient to constitute a constructive receipt. There must be a present right to receive. For example, credits of salary, dividends and interest in the usual case will be deemed to have been constructively received when recorded by solvent payors. Nevertheless, income, although credited to the taxpayer, is not constructively received if it is subject to substantial limitations or restrictions as to the time or manner of payment or condition upon which payment is to be made.

Whereas the doctrine of constructive receipt is applied to cash-basis taxpayers, the concept of revenue recognition is usually applied to the accrual basis of accounting. The two concepts are similar in that they both involve the timing of the recognition of revenue.

The general criteria to be met before the accountant will recognize revenue (that is, admit to his record that the firm has provided goods or services) are that (1) there must be objective evidence as to the measurability or market value of the output and (2) the earning process (in essence, all of the operations necessary to finance, create and market the given goods or services) must be substantially completed, at least to the extent that the revenues are recognized. The tests for recognition may rest upon an exchange transaction between independent parties, upon established trade practices or upon the terms of a contract, performance of which is considered to be virtually certain. In general, revenue is recognized at the point of sale. Traditionally it has been accepted generally that the exchange must result in the receipt of a liquid asset or the reduction of a liability. In this respect revenue recognition has some of the characteristics of constructive receipt.

b. 1. Interperiod tax allocation procedures are designed to adjust for the tax effects of transactions in which a revenue or expense item does not enter into the determination of both taxable and accounting income in the same period. Interperiod allocation of income taxes results in the recognition of tax effects in the same periods in which the related transactions are recognized in the determination of pretax accounting income. These procedures, in effect, view income tax expense as an expense of doing business which should be accrued and matched with related revenues in the same manner as other expenses.

Under interperiod tax allocation, income tax expense for a period includes the tax effects of transactions entering into the determination of pretax accounting income for the period even though some transactions may affect the determination of taxes payable in a different period.

2. Intraperiod tax allocation refers to the allocation of income taxes within a period. The need for tax allocation within a period arises because items included in the determination of taxable income may be presented for accounting purposes as (1) extraordinary items, (2) adjustments of prior periods (or of the opening balance of retained earnings) or (3) direct entries to other stockholders' equity accounts.

Intraperiod tax allocation clarifies the reporting on results of operations because the impact of income taxes on operating income is more readily apparent. The income tax expense attributable to income before extraordinary items is computed on the revenue and expense transactions entering into the determination of that income. The income tax expense attributable to other items is determined by the tax consequences of transactions involving these items.

c. For tax purposes an involuntary conversion occurs when property in whole or in part is stolen, seized in condemnation proceedings, accidentally destroyed or is sold or exchanged because of the threat or imminence of condemnation proceedings, and the taxpayer receives insurance or a condemnation award or other property in exchange for the original property.

Losses may or may not be recognized under the rules of taxation. A loss is deductible only to the extent that it is incurred in a trade or business, in a transaction entered into for profit or from a theft or casualty. Gains, however, receive special treatment.

If property is converted directly into other property similar or related in service or use to the original property, no gain is recognized. This nonrecognition of gain is mandatory. But if the property is converted into money or into property not similar or related in service or use to the converted property (as through receipt of insurance or condemnation proceeds), the taxpayer may replace the converted property under certain conditions and avoid the recognition of gain. [These conditions are (1) the property is replaced within the time limit as specified by the Internal Revenue Regulations, (2) the replacement property is similar or related in service or use to the property converted and (3) the taxpayer makes the proper election when filing his return. The gain will be recognized only to the extent that the amount realized from the involuntary conversion exceeds the cost of the replacement property.]

For financial accounting purposes, gains and losses are recognized on involuntary conversions at the point of conversion or when the change in value has become sufficiently objective and definite to warrant recognition. There is no provision for deferring the gain as is provided in income tax accounting. However, since the net gain will eventually be recognized even under income tax accounting, the essential difference lies in the timing of the recognition of the gain.

Solutions and Answers to Examination November 1971

Solutions and Answers to Examination

ACCOUNTING PRACTICE—PART I

November 3, 1971; 1:30 to 6:00 p.m.

Solution 1

1. a
2. a
3. b
4. c
5. d
6. b
7. c
8. e
9. d
10. b
11. e
12. d
13. e
14. c
15. c

Solution 2

a.

Mercury Corporation

SCHEDULE SHOWING THE COMPUTATION OF DEPRECIATION EXPENSE FOR USED AND NEW BUILDINGS AND NEW MACHINERY
For 1970

Used building:			
Depreciation expense ($3,000,000 ÷ 30)			$100,000
New building:			
Cost		$6,000,000	
Declining-balance percentage		.0375	225,000
Machinery:			
Additional first-year 20% depreciation bonus ($10,000 maximum × 20%)		2,000	
Cost	$398,000		
Less first-year 20% depreciation bonus	2,000		
Basis remaining for regular depreciation	396,000		
Double-declining-balance percentage	.20	79,200	81,200
Depreciation expense for used and new buildings and new machinery			$406,200

b. **Mercury Corporation**

SCHEDULE SHOWING THE COMPUTATION OF DEPRECIATION EXPENSE AND RECAPTURE OF DEPRECIATION FOR NEW BUILDING SOLD
For 1970

Year	*Depreciation Expense Deducted*	*Straight-line Depreciation*	*Excess*
1967	$ 50,000	$25,000	$25,000
1968	47,500	25,000	22,500
1969	45,125	25,000	20,125
	$142,625	$75,000	$67,625
1970	$ 42,869	$25,000	$17,869

Pre-1970 excess depreciation	$67,625	
Percentage subject to recapture (100% minus 27% for 27 full months held over 20 months)	.73	
Pre-1970 excess depreciation recapture	49,366	
Post-1969 excess depreciation	17,869	
Total Section 1250 recapture—ordinary income		$67,235
Gain on sale of building	$92,000	
Section 1250 ordinary income	67,235	
Section 1231 gain		$24,765

c. **Mercury Corporation**

SCHEDULE SHOWING THE COMPUTATION OF DEDUCTION FOR BAD DEBTS EXPENSE AND THE ADDITION TO THE ALLOWANCE FOR UNCOLLECTIBLE ACCOUNTS RECEIVABLE
For 1970

Accounts receivable at December 31, 1970		$1,200,000
Per cent that ultimately becomes uncollectible		.02
Amount estimated to be uncollectible		24,000
Allowance balance on January 1, 1970	$16,000	
Less receivables which became worthless and were written off in 1970	13,500	2,500
Addition to allowance and the amount of bad debt expense deductible for 1970		$ 21,500

d. **Mercury Corporation**

SCHEDULE SHOWING THE COMPUTATION OF THE EFFECT ON TAXABLE INCOME OF ORGANIZATION COSTS, SALE OF DONATED LAND AND RENT DISTRIBUTED TO STOCKHOLDERS
For 1970

Amortization expense:			
Amortization period—months	60		
Less months of amortization taken in prior periods	54		
Months remaining	6		
Amortization expense (6/60 × $90,000)			$ 9,000
Gain on sale of land:			
Sales price of one-half tract of donated land		$ 45,000	
Basis of one-half of donated property		0	$45,000
Rental revenue under the lease			$12,000

e. **Mercury Corporation**

SCHEDULE SHOWING THE EFFECT ON INCOME OF COMPUTER-BASED INFORMATION SYSTEM COSTS
For 1969 and 1970

		1969	*1970*
Hardware:			
Cost of hardware	$550,000		
Add included costs of software	75,000		
Costs to be depreciated over 8 years	$625,000		
Additional first-year 20% depreciation bonus ($10,000 maximum × 20%)		$ 2,000	
Cost	$625,000		
Less first-year 20% depreciation bonus	2,000		
Basis remaining for regular depreciation	623,000		
Double-declining-balance percentage	.25		
Depreciation expense for hardware and included costs		155,750	$116,812
Separately stated software costs:			
(Since the life of separately stated costs of software is not determinable, amortization will be over a five-year period.)			
($160,000 ÷ 5)		32,000	32,000
Fees for control system		15,000	
Deductible computer-based information system expenses		$204,750	$148,812

Solution 3

a.

Ballinger Paper Products
Materials Department

COST OF PAPER USED
For June 1971

	Units (Square Feet)	*Unit Cost*	*Amount*
Inventory, June 1	390,000	—	$ 76,000
New units	1,210,000	—	244,000
Units available	1,600,000	$.20	320,000
Inventory, June 30	200,000	.20	40,000
Transferred out	1,400,000	.20	$280,000

b.

Ballinger Paper Products

SCHEDULE OF PHYSICAL FLOW OF PAPER
For June 1971

	Materials Department	*Box Department*	*Finished Goods Department*
	Paper (Square Feet)	*Work in Process (Boxes)*	*Completed Boxes*
Inventory, June 1	390,000	800,000	250,000
New units	1,210,000	5,600,000*	6,000,000
Total	1,600,000	6,400,000	6,250,000
Initial spoilage	—	(30,000)	—
Terminal spoilage	—	(70,000)	—
Inventory, June 30	(200,000)	(300,000)	(50,000)
Transferred out	1,400,000*	6,000,000	6,200,000

* The 1,400,000 units transferred out of the Materials Department are reclassified on a 4 to 1 basis to 5,600,000 units in the Box Department.

c.

Ballinger Paper Products
Box Department

EQUIVALENT PRODUCTION UNITS
For June 1971

	Material	*Conversion Cost*
Transferred out—good	6,000,000	6,000,000
Inventory, June 30	300,000	150,000
Inventory, June 1	(800,000)	(400,000)
Equivalent production	5,500,000	5,750,000

d.

Ballinger Paper Products
Box Department
COMPUTATION OF UNIT COSTS
For June 1971

	Material			*Conversion Cost*			*Total*
	Units	*Unit Cost*	*Amount*	*Units*	*Unit Cost*	*Amount*	*Unit Cost*
Equivalent production	5,500,000	—	$280,000	5,750,000	—	$226,000	
Inventory, June 1	800,000	—	35,000	400,000	—	20,000	
Total	6,300,000	$.05	$315,000	6,150,000	$.04	$246,000	$.09

e.

Ballinger Paper Products
Box Department
REPORT OF INVENTORY VALUATION AND COST OF COMPLETED UNITS
For June 1971

	Material			*Conversion Cost*			*Total*
	Units	*Unit Cost*	*Amount*	*Units*	*Unit Cost*	*Amount*	*Cost*
Total units	6,300,000	$.05	$315,000	6,150,000	$.04	$246,000	$561,000
Inventory, June 30	300,000	.05	15,000	150,000	.04	6,000	21,000
Completed units	6,000,000	.05	$300,000	6,000,000	.04	$240,000	$540,000

f.

Ballinger Paper Products
Finished Goods Department
COMPUTATION OF UNIT COSTS
For June 1971

	Completed Units	*Unit Cost*	*Amount*
Inventory, June 1	250,000	—	$ 18,000
Units accepted	6,000,000	—	540,000
Total available	6,250,000	$.0893	$558,000

g.

Ballinger Paper Products
Finished Goods Department
REPORT OF INVENTORY VALUATION AND COST OF UNITS SOLD
For June 1971

	Units	*Unit Cost*	*Amount*
Total available	6,250,000	$.0893	$558,000
Inventory, June 30	50,000	.0893	4,465
Cost of units sold	6,200,000	.0893	$553,535

Solution 4

a.

Helen Corporation

WORKING PAPER TO COMPUTE THE EFFECTS OF ERRORS UPON FINANCIAL STATEMENTS

December 31, 1970

	Income 1968		Income 1969		Income 1970		Balance Sheet Corrections at December 31, 1970		
							Amount		
Explanation	*Debit*	*Credit*	*Debit*	*Credit*	*Debit*	*Credit*	*Debit*	*Credit*	*Account*
1. Sales tax accruals omitted:									
December 31, 1968	$2,130			$ 2,130					
December 31, 1969			$ 2,550			$ 2,550			
December 31, 1970					$2,850			$ 2,850	Sales tax payable
2. Unrecorded depreciation of furniture and fixtures	1,200		1,200		1,200			3,600	Accumulated depreciation — furniture and fixtures
3. Machinery cost incorrect		$ 5,700					$ 5,700		Machinery
Machinery depreciation incorrect				150		300	450		Accumulated depreciation — machinery
4. Merchandise inventory and accounts payable misstated —no effect									
5. Merchandise inventory misstated:									
December 31, 1969				6,550	6,550				
December 31, 1970					2,180			2,180	Merchandise inventory
6. Accrued salaries omitted					1,925			1,925	Salaries payable
7. Cash and accounts receivable misstated—no effect									
8. Timing error in recording dividends—no effect on income:									
December 31, 1970							2,500		Retained earnings
								2,500	Dividends payable
9. Prepaid advertising omitted		1,360	1,360						

Explanation	Income 1968 Debit	Income 1968 Credit	Income 1969 Debit	Income 1969 Credit	Income 1970 Debit	Income 1970 Credit	Balance Sheet Corrections at December 31, 1970 Amount Debit	Amount Credit	Account
10. Cash shortage					48			48	Cash
11. Premium on stock incorrectly recorded—no effect on income							5,000		Common stock
								5,000	Paid-in capital in excess of par value
12. Incorrect recording of bad debts	6,100		2,250		800			9,150	Allowance for bad debts
13. Bond discount charged to expense				1,900	100		1,800		Bond discount
Bond interest accrual omitted:									
December 31, 1969			3,000			3,000			
December 31, 1970					3,000			3,000	Interest payable
14. Pension costs misstated:									
Past service cost amortized over 10 years						22,500	22,500		Prepaid pension costs
Cost applicable to current services					1,600			1,600	Unfunded actuarial liability
15. Property tax deferrals omitted:									
December 31, 1968		7,800	7,800						
December 31, 1969				8,040	8,040				
December 31, 1970						7,950	7,950		Deferred property tax
	$9,430	$14,860	$18,160	$18,770	$28,293	$36,300	$45,900	$31,853	
Increase in income		$ 5,430		$ 610		$ 8,007			

b. **Helen Corporation**

SCHEDULE SHOWING COMPUTATION OF INCOME TAX EXPENSE AND LIABILITY

	1968	*1969*	*1970*
Accounting income	$180,000	$212,000	$252,000
Add rent revenue not included in accounting income	750		
	180,750	212,000	252,000
Less:			
Excess of tax return depreciation over accounting depreciation	20,000	17,000	10,000
Interest revenue (on municipal bonds)	3,000	3,000	3,000
Rent revenue included in accounting income		750	
Total deduction	23,000	20,750	13,000
Taxable income	$157,750	$191,250	$239,000
Income tax liability (40%)	$ 63,100	$ 76,500	$ 95,600
Income tax expense:			
40% × $177,000 ($180,000 — $3,000 interest)	$ 70,800		
40% × $209,000 ($212,000 — $3,000 interest)		$ 83,600	
40% × $249,000 ($252,000 — $3,000 interest)			$ 99,600

Solution 5

16. a
17. b
18. c
19. b
20. d
21. b
22. a
23. a
24. d
25. d
26. d
27. e
28. b
29. a
30. e
31. c
32. b
33. c

Solution 6

City of Delmas

ADJUSTING JOURNAL ENTRIES
June 30, 1971

Intragovernmental Service Fund (Working Capital Fund)

(1)

Cash	$12,200	
Land	14,500	
Building	67,500	
Machinery and Equipment	33,000	
Contribution from General Fund		$127,200
To record acquisition of central garage and transfer of cash for its operation from General Fund.		

(2)

Due from General Fund	2,000	
Cash	30,000	
Billings to Departments		32,000
To record revenues of central garage.		

(3)

Inventory of Materials and Supplies	1,500	
Cost of Materials and Supplies Used	8,000	
Office Salaries	6,000	
Utilities	700	
Mechanics' Wages	11,000	
Accounts Payable		500
Cash		26,700
To record inventory, cash expenses and unrecorded liabilities.		

(4)

Depreciation—Building	1,350	
Depreciation—Machinery and Equipment	1,100	
Allowance for Depreciation—Building		1,350
Allowance for Depreciation—Machinery and Equipment		1,100
To record depreciation for the six months ended June 30, 1971.		

Special Assessment Fund

(1)

Special Assessments Receivable—Current	$ 42,000	
Special Assessments Receivable—Deferred	168,000	
Due from General Fund	15,000	
Fund Balance		$225,000
To record special assessment levy.		

(2)

Cash	200,000	
Bonds Payable		200,000
To record issue of special assessment bonds at par.		

Capital Projects Fund (Bond Fund)

(1)

Cash	2,500	
Fund Balance		2,500
To record health center capital project.		

Debt Service Fund (Sinking Fund)

(1)

Required Additions	29,060	
Required Earnings	304	
Expenditures	24,000	
Cash	17,364	
Investments	5,060	
Appropriations		24,000
Revenues		29,060
Interest Earnings		304
Interest Payable		12,000
Fund Balance		10,424
To record debt service fund for health center bonds.		

General Fixed Assets Group of Accounts (General Fixed Assets)

(1)

Buildings	397,500	
Investment in General Fixed Assets from Capital Projects Funds: General Obligation Bonds		397,500
To record construction of health center.		

General Long-Term Debt Group of Accounts (General Bonded Debt and Interest)

(1)

Amount Available in Debt Service Funds—Term Bonds	10,424	
Amount to be Provided for Payment of Term Bonds	389,576	
Term Bonds Payable		400,000
To record liability for health center bonds and amount available for their retirement.		

ACCOUNTING PRACTICE—PART II

November 4, 1971; 1:30 to 6:00 p.m.

Solution 1

1. d	9. e
2. d	10. a
3. e	11. c
4. c	12. d
5. a	13. a
6. a	14. b
7. e	15. b
8. c	

Solution 2

16. d	25. a
17. d	26. d
18. a	27. e
19. c	28. c
20. a	29. b
21. b	30. b
22. d	31. a
23. c	32. b
24. e	33. e

Solution 3

a. **Beke and Quinn Partnership**

COMPARATIVE STATEMENT OF ASSETS AT HISTORICAL COST AND AT CURRENT REALIZABLE VALUE
June 30, 1971

	Historical Cost	*Current Value*
Cash	$ 500,500	$ 500,500
Accounts receivable, net	950,000	912,500
Inventory	1,500,000	1,648,500
Prepaid insurance	18,000	18,000
Land	58,000	70,000
Machinery and equipment, net	1,473,500	1,841,875
	$4,500,000	$4,991,375

Computation of Current Value of Accounts Receivable

Fiscal Year	*Amount Per Books*	*Allowance Required in Per cent*	*Amount of Allowance Required*	*Net Accounts Receivable*
1968	$ 40,000	100%	$ 40,000	$ —0—
1969	125,000	100	125,000	—0—
1970	160,000	50	80,000	80,000
1971	925,000	10	92,500	832,500
	$1,250,000		$337,500	$912,500

Computation of Current Value of Inventory

Fiscal Year	*Inventory by Years at Cost*	*Price Increase in Per cent*	*Increase in Dollars*	*Current Value June 30, 1971*
1967	$ 60,000	20%	$ 12,000	$ 72,000
1968	150,000	18	27,000	177,000
1969	240,000	15	36,000	276,000
1970	350,000	11	38,500	388,500
1971	700,000	5	35,000	735,000
	$1,500,000		$148,500	$1,648,500

Computation of Current Value of Machinery and Equipment

Fiscal Year of Purchase	*Original Cost*	*Accumulated Depreciation in Per cent*	*Amount of Accumulated Depreciation*	*Book Value*
1967	$ 500,000	45%	$225,000	$ 275,000
1969	850,000	25	212,500	637,500
1970	660,000	15	99,000	561,000
	$2,010,000		$536,500	$1,473,500

Current value: 125% × $1,473,500 = $1,841,875

b. **Preston Corporation**

JOURNAL ENTRY TO RECORD POOLING OF INTERESTS WITH BEKE AND QUINN PARTNERSHIP
July 1, 1971

Cash	$ 500,500	
Accounts receivable	1,250,000	
Inventory	1,500,000	
Prepaid expenses	18,000	
Land	58,000	
Machinery and equipment	2,010,000	
Allowance for doubtful accounts		$ 300,000
Accumulated depreciation		536,500
Current liabilities		1,475,000
Capital stock		1,450,000
Additional paid-in capital		50,000
Retained earnings		1,525,000

To record the issuance of stock for the assets, liabilities and partners' capital of Beke and Quinn Partnership acquired in a pooling of interest. The sum of capital stock and additional paid-in capital is equal to the partners' original investment. Retained earnings is the amount of earnings not withdrawn from the partnership.

Solution 4

a. **Thorne Transit, Inc.**

SCHEDULE TO COMPUTE ESTIMATED ANNUAL REVENUE

	32-Passenger Buses	*52-Passenger Buses*
Capacity per trip	32	52
Trips by each bus during rush hours	× 12	× 12
Rush hour passengers carried by each bus	384	624
Number of buses	× 6	× 4
Total rush hour passengers carried daily	2,304	2,496
Total other passengers daily	500	500
Total daily passengers	2,804	2,996
Days per year	×260	×260
Total passengers carried annually	729,040	778,960
Fare per passenger	$.50	$.50
Total annual revenue	$364,520	$389,480

b. **Thorne Transit, Inc.**

SCHEDULE TO COMPUTE ESTIMATED ANNUAL DRIVERS' WAGES

	32-Passenger Buses	*52-Passenger Buses*
Buses operating daily during rush hours	6	4
Rush hours	× 4	× 4
Rush hour time for all drivers	24	16
Buses operating remainder of day	4	4
Remaining hours	× 12	× 12
Regular driving time, excluding rush hours	48	48
Total daily driver hours	72	64
Days per year	×260	×260
Total annual driver hours	18,720	16,640
Hourly wage rate	×$3.50	×$4.20
Total annual drivers' wages	$65,520	$69,888

c. **Thorne Transit, Inc.**

SCHEDULE TO COMPUTE ESTIMATED ANNUAL COST OF GASOLINE

	32-Passenger Buses	*52-Passenger Buses*
Buses operating during rush hours	6	4
Rush hour mileage per bus	×120	×120
Total rush hour mileage	720	480
Buses operating during remainder of day	4	4
Mileage per bus, remainder of day	×360	×360
Total mileage for remainder of day	1,440	1,440
Total daily mileage	2,160	1,920
Days per year	×260	×260
Total annual mileage	561,600	499,200
Miles per gallon	÷ 10	÷ 7½
Annual gallons of gasoline consumption	56,160	66,560
Price per gallon	$.30	$.30
Total annual cost of gasoline	$16,848	$19,968

d. **Thorne Transit, Inc.**

SCHEDULE TO COMPUTE PRESENT VALUE OF NET CASH FLOWS

		32-Passenger Buses		*52-Passenger Buses*
Estimated revenues		$365,000		$390,000
Estimated cash expenses:				
Drivers' wages	$ 67,000		$ 68,000	
Gasoline	16,000		18,000	
Other	4,000	(87,000)	3,000	(89,000)
Net annual cash income		278,000		301,000
Present value factor		×4.97		×4.97
Present value of net cash flows from operations		$1,381,660		$1,495,970
Purchase price		(480,000)		(440,000)
Salvage value	$ 36,000		$ 28,000	
Present value factor	.40	14,400	.40	11,200
Net present value of cash flows		$ 916,060		$1,067,170

Solution 5

Acme Investing Company

ANALYSES OF INVESTMENTS AND INVESTMENT REVENUE
For the Year Ended September 30, 1971

Date	Description	Balance Oct. 1, 1970	Recorded Transactions Debit	Recorded Transactions Credit	Balances, Sept. 30, 1971 Investments Debit	Balances, Sept. 30, 1971 Investment Revenue Credit	Adjusting and Reclassifying Entries Debit	Adjusting and Reclassifying Entries Credit	Adjusted Balances, Sept. 30, 1971 Investments Debit	Adjusted Balances, Sept. 30, 1971 Investment Revenue Credit
	Investments Account:									
Oct. 1, 1970	Syntechnique — 2,000 shares, at cost	$ 120,000								
Jan. 1, 1971	Syntechnique — purchased 2,000 shares		$160,000							
July 3, 1971	Syntechnique — sold 2,000 shares			$ 100,000	$ 180,000		(2) $ 40,000	(7) $ 220,000		
Oct. 1, 1970	Good Systems — 10,000 shares, at cost	38,000			38,000		(3) 8,200		$ 46,200	
Oct. 1, 1970	Sure-Hit Mines — 1,000 shares, at cost	21,500			21,500			(4) 6,200	15,300	
Aug. 1, 1971	Purchase of 7% Cass County bonds		588,000		588,000		(6) 500	(5) 14,000	574,500	
Oct. 1, 1970	Raiborn Corp., at equity	607,000	15,000		622,000		(9) 22,000	(8) 15,000	629,000	
Oct. 1, 1970	Mercan Ltd. — 400 shares, at cost	900,000								
	Mercan Ltd. — serial loan maturing 1988	750,000		50,000	1,600,000			(10) 50,000	1,550,000	
Oct. 1, 1970	Undeveloped real estate, at cost	6,000,000								
Apr. 15, 1971	Proceeds from sale of one-half of undeveloped real estate			4,700,000	1,300,000		(13) 1,700,000		3,000,000	
		$8,436,500	$763,000	$4,850,000	$4,349,500					

					Balances, Sept. 30, 1971		Adjusting and Reclassifying Entries		Adjusted Balances, Sept. 30, 1971	
		Balance	Recorded Transactions		Investments	Investment Revenue			Investments	Investment Revenue
Date	*Description*	*Oct. 1, 1970*	*Debit*	*Credit*	*Debit*	*Credit*	*Debit*	*Credit*	*Debit*	*Credit*
	Investment Revenue Account:									
	Various Syntechnique cash dividends			$ 13,500		$13,500		(1) 4,500		18,000
May 21, 1971	Good Systems—stock assessment		$ 8,200			(8,200)		(3) 8,200		
June 15, 1971	Sure-Hit Mines—cash distribution			15,500		15,500	(4) 6,200			9,300
July 15, 1971	Raiborn Corp.—cash dividend			20,000		20,000				20,000
Oct. 1, 1970	Mercan Ltd. — interest accrual reversing entry		9,375			(9,375)				(9,375)
Aug. 1, 1971	Mercan Ltd. — interest received			56,250		56,250				56,250
			$17,575	$ 105,250		$87,675				

Solution 5

Date	Description	Balance Oct. 1, 1970	Recorded Transactions Debit	Recorded Transactions Credit	Balances, Sept. 30, 1971 Investments Debit	Balances, Sept. 30, 1971 Investment Revenue Credit	Adjusting and Reclassifying Entries Debit	Adjusting and Reclassifying Entries Credit	Adjusted Balances, Sept. 30, 1971 Investments Debit	Adjusted Balances, Sept. 30, 1971 Investment Revenue Credit
	Accounts Used in Adjustments									
	Dividends receivable						(1) 4,500			
	Gain on sale of securities							(2) 40,000		
	Accrued interest receivable						(5) 21,000			
							(11) 8,750			
	Investment revenue—Cass County bonds							(5) 7,000 (6) 500		7,500
	Marketable securities, at cost						(7) 220,000			
	Advance to domestic subsidiary						(8) 15,000			
	Investment revenue—Raiborn Corp.							(9) 22,000		22,000
	Loan to Mercan — current maturity						(10) 50,000			
	Investment revenue—Mercan							(11) 8,750		8,750
	Provision for foreign exchange losses						(12) 35,000			
	Allowance for foreign exchange losses — Investments — Mercan							(12) 35,000	(35,000)	
	Gain on sale of land							(13) 1,700,000		
							$2,131,150	$2,131,150	$5,780,000	$132,425

Acme Investing Company

ADJUSTING AND RECLASSIFYING ENTRIES
For Year Ended September 30, 1971
(Not Required)

(1)

	Debit	Credit
Dividends receivable	$4,500	
Investment revenue		$4,500

To recognize Syntechnique dividends for period as follows:

Record Date	Shares	Amount
12/26/70	2,000	$ 2,500
3/26/71	4,000	5,000
6/26/71	8,000	6,000
9/26/71	6,000	4,500
		18,000
Less amount recorded		13,500
		$ 4,500

(2)

	Debit	Credit
Investments—Syntechnique	40,000	
Gain on sale of securities		40,000

To recognize gain on sale of one-half the equity held in Syntechnique at the beginning of the period.

(3)

	Debit	Credit
Investments—Good Systems	8,200	
Investment revenue		8,200

To capitalize the assessment against Good Systems stockholders.

(4)

	Debit	Credit
Investment revenue	6,200	
Investments—Sure-Hit Mines		6,200

To recognize the liquidation of a portion of the investment in Sure-Hit Mines.

(5)

	Debit	Credit
Accrued interest receivable	21,000	
Investments—Cass County bonds		14,000
Investment revenue		7,000

To accrue interest receivable to September 30, 1971 and reduce the investment in Cass County bonds to the extent accrued interest was purchased.

(6)		
Investments—Cass County bonds	$ 500	
Investment revenue		$ 500
To recognize the amortization of discount applicable to the investment in Cass County bonds. ($600,000 — $574,000 = $26,000 $26,000 ÷ 104 months = $250 per month $250 × 2 months = $500)		
(7)		
Marketable securities	220,000	
Investments—Syntechnique		220,000
To reclassify the investment in Syntechnique as a current asset.		
(8)		
Advance to domestic subsidiary	15,000	
Investments—Raiborn		15,000
To separate the amount of current advances from the investment in Raiborn.		
(9)		
Investments—Raiborn	22,000	
Investment revenue		22,000
To record year's increase in investment in Raiborn to equity in underlying net assets as of September 30, 1971 ($60,000 × 70% = $42,000 — $20,000 cash dividend = $22,000).		
(10)		
Loan to Mercan—current maturity	50,000	
Investments—Mercan		50,000
To classify as current the portion of the loan to Mercan which is to be collected in the coming year.		
(11)		
Accrued interest receivable	8,750	
Investment revenue		8,750
To accrue interest receivable to September 30, 1971 on Mercan loan.		
(12)		
Provision for foreign exchange losses	35,000	
Allowance for foreign exchange losses—Investments—Mercan		35,000
To provide for losses on foreign exchange due to currency devaluation.		
(13)		
Investments—undeveloped real estate	1,700,000	
Gain on sale of land		1,700,000
To recognize the gain on the sale of one-half of the undeveloped real estate tract.		

AUDITING

November 4, 1971; 8:30 a.m. to 12:00 m.

Answer 1

1. b	10. c
2. a	11. d
3. a	12. a
4. b	13. c
*5. a or c	14. b
6. a	15. b
7. b	16. a
8. d	17. d
9. d	18. c

Answer 2

19. a	28. c
20. a	29. c
21. d	30. d
22. d	31. b
23. c	32. b
24. b	33. d
25. a	34. d
26. b	35. d
27. c	36. c

* There is support for both answers a and c. It is desirable that all financial statements presented in comparative form be comparable. The auditor is required only to report upon consistency with the preceding period, but he should disclose that he has not examined the financial statements for preceding years.

Answer 3

a. 1. The cutoff date is the date that a company stops transaction flow for purposes of financial closing. Most often this will coincide with the balance sheet date, but it may be a few days before or after. The period between cutoff and the balance sheet date should not include abnormal activity. A company may not use the same cutoff date for all transactions, but it should be consistent between accounting periods. A cutoff test generally involves the examination (on a test basis) of underlying support for transactions recorded during short periods before and after the balance sheet date (or other cutoff date). The auditor performs a cutoff test to determine whether transactions are recorded in the proper accounting period, establish that cutoff was consistent between periods and determine that activity was normal between cutoff and the balance sheet date.

2. The auditor must perform cutoff tests at the beginning and end of the audit period in order to assure himself that cutoff was consistent at the two dates and that a single period's revenues and expenses have been recorded within the period. If the auditor examined the prior year's statements, he would not repeat his beginning cutoff tests.

b. The CPA's test of the sales cutoff at June 30, 1971 should include the fol-following steps:

1. Determine what Houston's cutoff policy is, review the policy for reasonableness and compare it to the prior year for consistency.

2. Select a sample of sales invoices (including the last serial invoice number) from those recorded in the last few days of June and the first few days of July.

3. Trace these sales invoices to shipping documents and determine that sales have been recorded in the proper period in accordance with company cutoff policy.

4. Determine that the cost of the goods sold has been recorded in the period of sale.

5. Select a sample of shipping documents for the same period and trace these to the sales invoice. Determine that the sale and the cost of goods sold have been recorded in the proper period.

6. Review the cutoff for sales returns and allowances, determine that it has been based upon a consistent policy and that there have not been abnormal sales returns and allowances in July; this might indicate either an overstatement of sales during the audit period or the need for a valuation account at June 30, 1971 to provide for future returns and allowances.

c. 1. The CPA will use the July 10, 1971 cutoff bank statement in his review of the June 30, 1971 bank reconciliation to determine whether:

   a. The opening balance on the cutoff bank statement agrees with the "balance per bank" on the June 30, 1971 reconciliation.

   b. The June 30, 1971 bank reconciliation includes those canceled checks that were returned with the cutoff bank statement and are dated or bear bank endorsements prior to July 1.

   c. Deposits in transit cleared within a reasonable time.

   d. Interbank transfers have been considered properly in determining the June 30, 1971 adjusted bank balance.

   e. Other reconciling items which had not cleared the bank at June 30, 1971 (such as bank errors) clear during the cutoff period.

2. The CPA may obtain other audit information by:

   a. Investigating unusual entries on the cutoff bank statement.

   b. Examining canceled checks, particularly noting unusual payees or endorsements.

   c. Reviewing other documentation supporting the cutoff bank statement.

   Among the transactions or circumstances which these procedures might disclose are:

   a. Irregular payments or payments related to matters which the CPA should investigate. For example, he would want to learn the reason for an unusual legal fee or a payment to a Company officer.

   b. Borrowings in the new fiscal year or repayment of recorded or unrecorded loans outstanding at year-end.

   c. Abnormal sales returns during the new fiscal year.

   d. NSF checks applicable to the year ended June 30, 1971.

   e. Material expenditures during the cutoff period.

Answer 4

a. The concept of materiality refers to the relative significance of an account, activity or item to informative disclosure and a proper presentation of financial position and the results of operations. Materiality has qualitative and quantitative aspects; both the nature of the item and its relative size enter into its evaluation.

An accounting misstatement is said to be material if knowledge of the misstatement will affect the decisions of the average intelligent reader of the financial statements. Financial statements are misleading if they omit a material fact or include so many immaterial matters as to be confusing. In his examination, the auditor concentrates his efforts in proportion to degrees of materiality and relative risk and disregards immaterial items.

b. 1. The materiality of an account or activity and the results of the review of internal control determine the scope of the auditor's examination. Emphasis will not be uniform among engagements; for example, more attention will be paid to inventories in a manufacturing company than in a service company. In the former, inventories normally constitute a large portion of assets, and misstatement vitally affects net income. In contrast, the quantities of supplies on hand at a service company usually are minor.

2. In executing his audit program the auditor will stress review of the larger and more sensitive transactions. He cannot ignore the transactions which are immaterial by themselves and material cumulatively, but a lower sampling rate may be used.

When he finds errors, the auditor must assess the degree of significance. In doing this his concept of materiality will not be based solely upon the size of the error, particularly if the error was noted in a test rather than a 100% review. When critical (or significant) errors are discovered in tests, the auditor will generally extend the scope of his examination to confirm his finding. Once he has established an estimate of the degree of error present in the financial statements, he may then discuss with the client the necessity for adjustment.

c. The relevant criteria for assessing materiality will depend upon the circumstances and the nature of the item and will vary greatly among companies. For example, an error in current assets or current liabilities will be more important for a company with a flow of funds problem than for one with adequate working capital.

The effect upon net income (or earnings per share) is the most commonly used measure of materiality. This reflects the prime importance attached to net income by investors and other users of the statements. The effects upon assets and equities are also important as are misstatements of individual accounts and subtotals included in the financial statements. The auditor will note the effects of misstatements on key ratios such as gross margin, the current ratio or the debt-equity ratio and will consider such special circumstances as the effects on debt agreement covenants and the legality of dividend payments.

There are no rigidly accepted standards or guidelines for assessing materiality. The lower bound of materiality has been variously estimated at 5% to 20% of net income, but the determination will vary based upon the individual case and might not fall within these limits. Certain items, such as a questionable loan to a company officer, may be considered material even when minor amounts are involved. In contrast a large misclassification among expense accounts may not be deemed material if there is no misstatement of net income.

The CPA will be more concerned with the relative size of the item (in terms of the particular company's financial position and results of operations) than its absolute size. Usually he will base decisions upon the normal level of an account or activity—thus, if reported net income this year is $100,000, but based upon past experience and future expectations, normal net income is $1,000,000, an adjustment with an income effect of $20,000 probably will not be considered material unless unusual circumstances are involved. The income tax effect of errors also should be considered.

The auditor should determine and assess the effects of exceptions not only individually but also cumulatively. Adjustments passed in prior years because of immateriality should be included in this cumulative assessment to the extent that they affect the current year.

d. The CPA's assessment of the materiality of his exceptions to financial statements will influence his selection of the type of auditor's opinion as follows:

1. *Unqualified Opinion*

   If the effects of a misstatement are immaterial, the auditor will make no opinion qualification.

2. *Qualified Opinion*

   a. If the effects of a misstatement are material, but the auditor can still render an overall opinion as to financial position and the results of operations, he will qualify his opinion, generally by the use of phrases including the terms "except" or "exception."

   b. If his qualification is based upon an uncertain situation, but he can still render an overall opinion, the auditor will qualify his opinion by the use of a phrase including the term "subject to."

3. *Adverse Opinion*

   If an auditor's exceptions are so material that he feels the overall financial position or results of operations are not presented fairly, he will issue an adverse opinion. He will state that the financial statements do not present fairly the financial position or results of operations in conformity with generally accepted accounting principles. A disclaimer of opinion would not be appropriate in these circumstances.

4. *Disclaimer of Opinion*

   If the scope of his examination has been so limited, or such unusual uncertainties exist, that he does not have sufficient evidence to form an opinion upon the fairness of presentation of the financial statements as a whole, the auditor will disclaim any opinion on the financial statements.

5. *Piecemeal Opinion*

   In some cases where he concludes that he must express an adverse opinion or disclaim an opinion on the financial statements taken as a whole, the auditor may express a piecemeal opinion limited to certain items with which he is satisfied in the financial statements. The threshold of materiality ordinarily is lower for purposes of reporting on individual financial statement items. Rather than being measured in relation to the statements as a whole, the individual items stand alone, thus affording a smaller base. In deciding whether to express a piecemeal opinion, the auditor should consider all the circumstances including whether, in his judgment, a piecemeal opinion will serve a useful purpose.

Answer 5

a. 1. The audit objective of the CPA's review of the Federal Income Taxes Payable account is to form an opinion as to whether the current Provision for Federal Income Taxes and the balance of Federal Income Taxes Payable are properly stated.

The review of federal income tax returns for prior years and reports of internal revenue agents is a necessary procedure for the CPA to express an opinion as to the propriety of the Federal Income Taxes Payable account. He must establish that the client has provided for actual and potential liabilities for prior years. In addition, his review may disclose other matters of significance to his audit.

2. These reviews should enable the CPA to:
   a. Learn whether required returns, including estimated returns, have been filed on a timely basis and determine the status of internal revenue agent reviews of these returns.
   b. Note instances of proposed and probable deficiencies, penalties, assessments or interest on late payments and establish whether the company has provided for them.
   c. Establish whether disallowances by the revenue agent in prior years indicate problems for the current year.
   d. Learn of instances of improper financial accounting for revenues or expenses (but in many cases financial and tax accounting properly differ).
   e. Determine the differences between book and tax income and whether they have been properly accounted for and recognized in the current provision.
   f. Note whether the tax effect of loss carryforwards has been properly accounted for.
   g. Obtain leads concerning matters that might otherwise escape his attention, e.g., details of pension plans, exceptions to capitalization policy in prior years.
   h. Obtain a basis for making suggestions for future tax planning.

b. The CPA's primary responsibility is to determine whether the accrual for the year is proper. The company should claim all deductions to which it believes it is entitled, but it should provide for the probable deficiency as well as the taxes shown on the return as filed. If the amount is material, the CPA should insist upon this provision or render a qualified or adverse report. Most companies provide a cushion in the federal income tax provision for potential deficiencies. Making the provision does not influence the merit of the deduction and does not indicate acceptance of the disallowance.

In the event that the payment is completely unsupportable or has been concealed or inadequately disclosed, the CPA should impress upon the client (at an appropriate level) the seriousness of this situation and the potential consequences. He should urge discussions with legal and tax counsels and compliance with the tax laws. While he never would disclose his client's actions to the Internal Revenue Service because his relationship is confidential, he might conclude, if the situation were serious enough, that he should withdraw from this potentially embarrassing engagement. He certainly would refuse to take any part in preparation or review of the federal income tax return.

Answer 6

Item 1

a. Unless cumulative preferred dividends are involved, no recommendation by the CPA is required. Common stock dividend policy is understood by readers of financial statements to be discretionary on the part of the board of directors. The company need not commit itself to a prospective common stock dividend policy or explain its historical policy in the financial statements, particularly since dividend policy is to be discussed in the president's letter. If cumulative preferred dividends are omitted, this should be disclosed in the financial statements or a footnote.

b. No comment or opinion qualification is required in the auditor's report on the financial statements unless an omission of cumulative preferred dividends is not properly disclosed.

Item 2

a. The staff auditor reviewing the loan agreement misinterpreted its requirements. Retained earnings are restricted in the amount of $298,000, which was the balance of retained earnings at the date of the agreement. The nature and amount of the restriction should be disclosed in the balance sheet or a footnote to the financial statements.

b. Assuming Lancaster does not make the recommended disclosure, the nature of and amount of the restriction should be disclosed in the auditor's report, and the opinion should be appropriately qualified.

Item 3

a. The lease agreement with the Sixth National Bank meets the criteria for an installment purchase of property: (1) it is noncancelable; (2) the company may purchase the property at the expiration date at a nominal price, substantially less than probable fair value; (3) the property meets special needs of the lessee; (4) the lessee is obligated to pay property taxes, insurance and maintenance. Accordingly, Mr. Olds should recommend that the property and the related obligation be stated in the balance sheet at the appropriate discounted amount of future payments under the lease agreement. The income statement should include annual financing charges applicable to the unpaid obligation and amortization of the cost of the property based upon its useful life. Additional footnote disclosure may be desirable.

b. If Lancaster does not capitalize the installment purchase as recommended, Mr. Olds should explain the circumstances in his report and qualify his opinion as to conformity with generally accepted accounting principles (or express an adverse opinion, if the amounts involved are so material that in his judgment a qualified opinion is not justified).

Item 4

a. A competitive development of this nature normally is considered to be the second type of subsequent event, one that provides evidence with respect to a condition that did not exist at the date of the balance sheet, but in some circumstances the auditor might conclude that Lancaster's poor competitive situation was evident at year-end. In any event, this development should be disclosed to users of the financial statements because the economic recoverability of the new plant is in doubt and Lancaster may incur substantial expenditures to modify its facilities. Because the economic effects probably cannot be determined, the usual disclosure will be in a footnote to the financial statements. If the present recoverable value of the plant can be determined, Lancaster should consider disclosure of the Company's revised financial position in a pro forma balance sheet, assuming that this event is concluded to be evidence of a condition that did not exist at year-end. (Only if circumstances were such that it was concluded that this condition did exist at year-end should the financial statements for the year ended December 31, 1970 be adjusted for the ascertainable economic effects of this development.)

b. If Lancaster does not disclose this event as the auditor recommends, the financial statements are misleading. Mr. Olds should take exception to the adequacy of disclosure and, depending upon the degree of materiality, he may express an adverse opinion. A "subject to" opinion or disclaimer of opinion (neither of which is proper under the given assumption) might be justified if the development were adequately disclosed and the economic effects could not be determined.

The occurrence of this event after the completion of field work does not affect the need for disclosure. The auditor generally is responsible for inquiry as to subsequent events only to the end of field work and dates his report accordingly, but he has the responsbility to evaluate subsequent information if it comes to his attention.

Answer 7

a. A grandfather-father-son tape retention policy is one under which two predecessor tape files are held as back-up for the current file. This provides a method fo· reconstruction of the tape files in the event of accidental destruction of a tape used during processing. The use of this concept is illustrated as follows: At the end of period 3, a company holds master tapes as of the ends of periods 1 (grandfather) and 2 (father) and transaction tapes for periods 2 and 3. Transactions for period 3 are then processed with the father tape to form a son tape. Following the processing of period 3 transactions, the company holds master tapes as of the end of periods 1 (grandfather), 2 (father) and 3 (son) and transaction tapes for periods 2 and 3. The father tape can be replicated by processing the grandfather tape with period 2 transactions, and the son tape can be replicated by processing the father tape with period 3 transactions. Period 4 transactions are processed at the end of period 4 with the son tape (master file at the end of period 3) to form a new son file. The old son tape becomes the new father tape, the old father tape becomes the new grandfather tape and the old grandfather tape (end of period 1) together with the transaction tape for period 2 may be released. Should anything happen to the old son tape during the updating with period 4 transactions, it may be replicated from the father tape and the period 3 transactions.

b. Holding two generations of backup tapes generally provides adequate protection. An additional generation might be maintained if the tape file is crucial or if there is a high rate of tape destruction. Since all tapes are stored together, they are vulnerable to loss through a common catastrophe—fire, theft or malicious act. Reconstruction from predecessor tapes can only be effected if the predecessor tapes are in existence. For this reason it is desirable that at least one generation of backup tapes be maintained in a separate location that is well protected from environmental hazards such as fires or magnetic interference. Access to both storage areas should be limited, and the librarianship function should be specifically assigned.

c. 1. The extent of the CPA's participation in preparation of the special tape and of his review of the tape will depend upon his assessment of computer department capabilities and his evaluation of EDP controls, particularly the separation of data processing from the purchasing, accounts payable and disbursement functions. As a minimum, he should clearly indicate tape format and the data that he requires and must perform some testing to satisfy himself that all items have been included on the special tape. He may accomplish this by tracing items on a test basis from Company records to a print-out of the special tape and comparing print-out totals to Company records.

2. The CPA should maintain physical control over the special tape, the general computer audit programs and any print-outs prepared for him. He should take his programs and data directly to the machine operators and be present during the processing. He should keep confidential the transactions selected for review and the method for selecting them.

d. **Solt Manufacturing Company**

Schedule of Data to be Retained on the Special Tape

Source—Client Tape	*Item of Data*
Master file—vendor name	Vendor code Vendor name
Transaction file — expense detail	Voucher number Voucher date Invoice date Invoice number Purchase order number Debit account Amount
Transaction file—payment detail	Check number Check date

If the auditor plans to circularize vendors, he may also request addresses, either on this tape or in another listing.

BUSINESS LAW
(Commercial Law)

November 5, 1971; 8:30 a.m. to 12:00 m.

Answer 1

1. True	11. True	21. True
2. True	12. True	22. False
3. False	13. False	23. False
4. False	14. True	24. True
5. False	15. False	25. True
6. True	16. False	26. True
7. True	17. True	27. False
8. False	18. False	28. True
9. False	19. True	29. True
10. True	20. False	30. False

Answer 2

31. False	41. False	51. True
32. False	42. False	52. False
33. False	43. True	53. False
34. True	44. False	54. True
35. False	45. True	55. False
36. False	46. True	56. True
37. True	47. True	57. True
38. True	48. True	58. True
39. False	49. False	59. True
40. False	50. False	60. False

Answer 3

61. False	71. False	81. True
62. True	72. True	82. True
63. True	73. True	83. False
64. True	74. True	84. False
65. True	75. True	85. False
66. True	76. False	86. True
67. False	77. False	87. True
68. True	78. True	88. False
69. False	79. True	89. False
70. False	80. True	90. True

Answer 4

a. Yes. G. F. Riggs, Inc. had a valid insurable interest in the life of Maxwell at the time the insurance policy was procured. An insurable interest in the life of another includes a substantial economic interest in the continuation of the life of the insured. This type of insurance often is referred to as "key man" insurance and includes the officers and principal executives of a company. Maxwell's position in the Corporation, his level of compensation (salary plus commissions) and his receipt of the stock option all attest to his expected worth and importance to the Corporation. An additional factor is the potential need of the Corporation to have funds available in order to purchase the shares of stock which Maxwell could obtain via exercise of the option. Courts have been disposed favorably toward recognizing an insurable interest based upon the economic necessity of such arrangements.

The policy is not voided by misrepresentation of the age of the insured. Modern insurance law does not permit insurers to avoid their obligations on this basis. Instead, the amount of insurance purchased is reduced to that figure which the premiums paid would have purchased had the correct age been stated. Nor does the insured's suicide preclude recovery. Only under certain limited circumstances will suicide bar recovery. Normally the insurer must show (1) that the insured intended to commit suicide when he procured the policy and (2) that he did so. Here the insured neither owned the policy nor named the beneficiaries. Even if the insured were the owner, the period of time from the purchase of the policy to the suicide argues against the presence of intent.

b. An assignment of a fire insurance policy without the insurer's consent is invalid. The nature of the risk may be materially altered as the result of a transfer of real property to a new owner or a change in the use of the building. Hence, without a binder or an endorsement issued by the insurer to the new owner, the assignment does not in any way bind the insurer. Recovery, if any, must be sought elsewhere.

There are two possibilities. First, it would appear that the attorney who handled the closing was negligent in failing to obtain the insurer's consent to the assignment and an action could be maintained against him for such negligence. Second, an action could be maintained against the employee, but as a practical matter this normally would result in an uncollectible judgment.

The insurer would be obligated to pay under the policy if it consented to the assignment despite the employee's negligence since this is one of the risks assumed. It would seem that attributing the contributory negligence of the employee to the principal (Skidmore) would not be a bar to recovery.

Answer 5

a. 1. It would appear that Winston & Mall are liable to Fast Cargo Company for their negligence. The accounting firm failed to discharge its duty of care when, having discovered the exceptions in the form of the missing receiving reports, they merely called this to the attention of Harris, the chief accountant. It would appear mandatory that prior to submitting the auditor's report Mall should have insisted upon a satisfactory explanation of how these irregularities occurred or that a further investigation be made to see that valid receiving reports were properly filed. Winston & Mall will be liable to the extent that a proper exercise of care would have detected and prevented the theft and diversion of the materials. Once aware of irregularities the accountant must continue to exercise reasonable care in determining their cause.

2. It seems obvious that Mall should have done more than he did under the circumstances. As indicated above it would have been prudent to have determined the reason for the failure to properly use and file receiving reports. Prior to submitting the auditors' report it also would have been prudent to ascertain that valid receiving reports had been filed as promised. Not having received an adequate explanation, Mall should have gone beyond the chief accountant and contacted the chief executive officer or even the board of directors to report the discovery of these irregularities and the lack of an adequate explanation. In this way liability could have been avoided. Once having discovered the irregularity, the accountants had a duty to determine why the receiving reports were missing. It was clearly inadequate to merely report this to the chief accountant and to receive a verbal assurance not to worry.

b. It would appear that this is a case of fraud on the part of the auditors. They were aware of the material fact involving the escrow arrangement in the sale of the subsidiary. They also knew that such a fact would be relied upon by creditors in extending credit. Thus, it was fraudulent to omit any indication of this restriction upon the funds and their use. Generally, liability to third parties (i.e., those who are not in privity with the auditors) precludes recovery. However, where the conduct of the activities constitutes fraud, privity is not required and those who are harmed as a result of the fraud may recover against the auditors. Thus, those creditors who relied upon the financial statements to their detriment will be able to recover against Barton and his firm, Barton and Co., to the extent of the losses which resulted from the failure to disclose the facts involving the escrow arrangement on the sale of Mirror's subsidiary.

c. As a result of his failure to disclose that President Nance of Farber Corporation had borrowed substantial amounts of money from the Corporation, Harper is negligent, and in all probability also has committed fraud. Harper owed a duty of care and of honesty to the Corporation and indirectly to the stockholders. In failing to disclose the material fact involving the loan, he failed to discharge his duty to the above parties. The facts that Nance was the president of the Corporation, that he owned 51% of the Corporation and that the financial statements were for internal use only, do not limit Harper's liability. He will be liable to the extent that his failure to disclose the facts involving the loan caused loss to the Corporation. The users of the financial statements were entitled to receive the full facts.

Answer 6

a.

1. Yes. Ordinarily, shares of stock in a corporation are freely transferable. It is not unusual, however, for the stockholders of small, closed corporations to enter into agreements restricting the transfer of stock. Such agreements are valid and will be enforced by the courts if the restrictions are reasonable. An absolute restriction would be unreasonable; however, a restriction giving the corporation the right of first refusal is generally held to be reasonable, valid and enforceable.

2. No. Although the restriction on transfer may be reasonable and valid as between the stockholders, it will not be binding upon third parties having no notice of it; the notice requirement would be satisfied if the restriction were noted on the Corporation's stock certificates owned by Eckert and sold to Jordan.

b.

1. Eastern is authorized to engage only in phosphate-related business activities, so the plan to put it into the real estate development business would be *ultra vires*. Stockholders of Eastern who invested in a phosphate company might not want their investment used for any other purpose. It would make no difference whether the existing business was declining and the proposed new business promised greater profits. In situations where a corporation proposes to conduct *ultra vires* activities, objecting stockholders can enjoin the transaction by bringing an appropriate action against the corporation.

2. No. Although a corporation may act *ultra vires*, a fully executed transaction will not be set aside on this ground. Here the sale of Eastern's assets was a completed, fully executed transaction and the courts would not disturb it.

3. Where directors approve an *ultra vires* transaction and the corporation suffers damages as a result, the directors are liable to the corporation.

Thus, Eastern has a cause of action against the old directors. If Eastern fails to prosecute the action, its stockholders may do so by a derivative suit.

Answer 7

a. 1. The defense that the loan was not made on the same day that the security agreement was signed is invalid because Article 9 does not require the loan to be made on the same day. However, the bank's security interest does not attach to the collateral until it gives value which it did one week later.

2. The defense that the bank could not acquire a security interest in future inventory and future accounts receivable is invalid. Article 9 expressly permits the secured party to acquire a security interest in after-acquired property if the security agreement so provides. The security interest attaches to the after-acquired property when the debtor acquires rights in such after-acquired property.

3. The defense that the description of the collateral in the security agreement and financing statement was legally insufficient is invalid. Under Article 9 any description of personal property is sufficient, whether or not it is specific, if it reasonably identifies what is described. The recited descriptions reasonably identify the collateral.

b. 1. Yes. Article 9 of the Uniform Commercial Code expressly provides that the disposition of any collateral may be by public or private proceeding. However, every aspect of the public or private proceeding including the method, manner, time, place and terms must be commercially reasonable. Unless collateral is perishable or threatens to decline speedily in value or is of a type customarily sold on a recognized market, reasonable notification of the time and place of any public sale (or reasonable notification of the time after which any private sale or other intended disposition is to be made) must be sent by the secured party to the debtor and (except in the case of consumer goods) to any other party who has a security interest in the collateral and has duly filed a financing statement.

2. Yes. A secured party may, after default, propose to retain the collateral in satisfaction of the obligation. Written notice of such proposal shall be sent to the debtor and to any other secured party who has a security interest in the collateral and has duly filed a financing statement. If the debtor or other person entitled to receive notification objects in writing within 30 days from the receipt of notification or if any other secured party having a security interest in the same collateral objects in writing within 30 days after the secured party obtains possession, the secured party must dispose of the collateral. In the absence of such written objection the secured party may retain the collateral in satisfaction of the debtor's obligation.

3. Yes. At any time before the secured party has disposed of collateral or entered into a contract for its disposition under Section 9-504 or before the obligation has been discharged under Section 9-505(2) the debtor or any other secured party may, unless otherwise agreed in writing after default, redeem the collateral by tendering fulfillment of all obligations secured by the collateral as well as the expenses reasonably incurred by the secured party (a) in retaking, holding and preparing the collateral for disposition, (b) in arranging for the sale and (c) to the extent provided in the agreement and not prohibited by law, his reasonable attorney's fees and legal expenses.

Answer 8

a. Yes. Puppetland may enforce the contract against the Company. Here, Mandrake acted as agent for an undisclosed principal. An undisclosed principal is one who is represented by an agent who does not reveal the fact that he is acting in a representative capacity. The general rule is that the third party may, when the identity of the principal is established, hold the principal liable in the same manner as if his identity had been known.

b. Yes. Puppetland may enforce the contract against Mandrake. The general rule is that the third party who contracts with an agent acting on behalf of an undisclosed principal in the belief that he is contracting with the agent individually can enforce the contract against the agent.

c. Yes. The Company may enforce the contract against Puppetland. The undisclosed principal may disclose his identity at any time and enforce the contract with two exceptions not relevant here.

d. Yes. The pedestrian's estate may recover against Mandrake since every agent is personally liable for his own torts whether acting for a disclosed or an undisclosed principal or whether acting within or outside the scope of his employment. The Company, as principal whether disclosed or undisclosed, is liable to third parties only if the agent's tort was committed while in the course of the agent's employment. Here the tort was committed during the course of Mandrake's employment as agent. His intoxication and his violation of Company policy does not relieve the principal of its liability to third parties under the doctrine of respondent superior. Here the Company and Mandrake are jointly and severally liable, but the estate is entitled to only one satisfaction.

e. Yes. The Company has the right to recover against Mandrake if it incurs any liability to the pedestrian's estate. An agent has the duty to obey all lawful instructions given by his principal. The instructions, as here, may depart from the usual procedure; they may appear impractical or even capricious to the agent. The agent therefore must answer to the principal for any loss which results from the disobedience of all lawful instructions. Thus Mandrake must indemnify his principal for any loss sustained.

ACCOUNTING THEORY
(Theory of Accounts)

November 5, 1971; 1:30 to 5:00 p.m.

Answer 1

1. a	11. d
2. b	12. b
3. d	13. a
4. b	14. d
5. c	15. c
6. b	16. a
7. a	17. d
8. a	18. d
9. c	19. c
10. a	20. b

Answer 2

21. b	31. b
22. d	32. c
23. b	33. d
24. c	34. a
25. c	35. a
26. d	36. b
27. c	37. b
28. b	38. d
29. a	39. c
30. a	40. a

Answer 3

a. 1. A "secret reserve" is created when stockholders' equity is understated. Generally, such reserves, often called hidden assets, are created or enlarged by practices which understate assets and/or overstate liabilities. Such practices often result from the application of the accounting convention or principle of conservatism.

2. Both of the practices cited tend to cause assets to be stated at lower amounts than would be the case with other acceptable alternatives. The use of LIFO during a period of steadily rising prices tends to cause the inventory cost to be stated in terms of prices that prevailed when the method was adopted. When such prices are compared to current prices they are low; hence income and stockholders' equity are correspondingly low. The expensing of all human resource costs as they are incurred, in effect, denies that such costs have produced any future benefits. To the extent that such expenditures produce future benefits, a portion of the costs should be capitalized as intangible assets. "Secret reserves" exist to the extent that assets have been understated by the expensing of all human resource costs immediately.

3. It is possible to create a "secret reserve" by overstating liabilities. This could most readily occur in recording estimated liabilities such as for product warranties or pensions at amounts in excess of actuarially determined amounts or for the restoration of property at the termination of a lease. Any such overstatement of the ultimate liability overstates current expenses and thereby understates stockholders' equity. A "secret reserve" also would exist when a firm has long-term, fixed interest debt outstanding during periods when interest rates are increasing and much higher than on the debt.

In a sense the concept of "secret reserves" also can be extended to include the effects of holding an excess of monetary liabilities over monetary assets. During a period of inflation the "reserve" is in terms of general purchasing power whereas the previously discussed "reserves" have been due to differences in money amounts.

4. There are several objections to the creation of "secret reserves." Only insiders are likely to know of their existence and value. Statement readers who are unaware of the existence of "secret reserves" may regard a company's securities as overvalued when, in fact, they may be undervalued or valued correctly. As a result, stockholders may be willing to part with their shares for too little consideration.

The creation of "secret reserves" also tends to shift income between periods and usually to have a smoothing effect on reported income. If an asset is understated or a liability is overstated in the current period, it usually means that some expense is going to be correspondingly overstated with the result that current income is understated. In some subsequent period the service potential of the unrecognized or undervalued asset will be consumed. If its cost were understated or not recognized, expenses of the later period also will be understated and income of the later period will be overstated. Somewhat the same effect can be achieved through overaccrual of estimated expenses. There are practical limits as to how large an estimated liability for estimated expenses can become before it will be discovered and investigated. In the period when the carrying value of the estimated liability reaches its upper limit, usually no accrual or an inadequate accrual is recognized.

Involved also is an application of the concept of organization slack. During expansionary periods a cushion is accumulated by overstating expenses or understating revenues. This cushion can be utilized when the environment becomes unfavorable such as during a period of depressed income caused by either external or internal factors. Thus "secret reserves" are a form of organization slack that gives management "squirming room" and helps it to smooth unfavorable reports under the assumption that bad news should be softened to prevent expectations (aspirations) from fluctuating widely.

The purpose of financial statements is to inform, not to mislead. The existence of "secret reserves" makes the statements misleading to the extent that assets are understated or liabilities are overstated because the extent of the under- or overstatement is not reported.

b. 1. A corporation's stock can be said to be "watered" if the stockholders' equity is overstated because assets are correspondingly overstated or because liabilities are understated.

2. "Watered stock" most commonly arises because assets for which the stock is issued are overvalued. One common motivation for such an issuance is to avoid showing a discount on capital stock when stock has been recorded as issued at par for assets having a fair market value equal to or greater than par when the value of the assets received was much less. Somewhat less likely is the understatement of liabilities in connection with the issuance of stock. If stock is issued for property subject to a mortgage, understating or ignoring the actual liability could result in an overvaluation of the stock.

3. The writing down of overstated assets or the writing up of understated liabilities would eliminate "water" from the stock. The offsetting charge to such credits might be made to retained earnings or preferably to another capital account. If some of the excess shares are recaptured, the appropriate charge would be to a capital stock account.

Answer 4

a. Two primary criteria must be met before revenue is recognized: (1) the related earning process must be substantially completed and (2) there must be objective evidence of the market value of the output—this often is interpreted to require that an exchange has taken place—and is usually referred to as realization. Several issues arise when applying these principles in accounting for the initial franchise fee. The first concerns the time of recognition of the fee as revenue—to which of several possible periods should it be assigned. The second relates to the amount of revenue to be recognized and this, in turn, is partially a question of the valuation of the notes received. Possible alternative methods are illustrated and evaluated as follows:

			or	
1. Cash	$ 5,000		$ 5,000	
Notes Receivable	20,000		15,163	
Discount on Notes Receivable		$ 4,837		
Unearned Initial Franchise Fee		20,163		$20,163

This method would be appropriate if (a) there was a reasonable expectation that the down payment may be refunded, and (b) substantial future services are to be provided to the franchisee, that is, performance by the franchisor has not yet occurred. If the notes called for the payment of interest at the going rate, there would be no need for the Discount on Notes Receivable and the Unearned Initial Franchise Fee would be $25,000.

			or	
2. Cash	$ 5,000		$ 5,000	
Notes Receivable	20,000		15,163	
Discount on Notes Receivable		$ 4,837		
Earned Initial Franchise Fee		20,163		$20,163

This method would be acceptable if (a) the probability of refunding the initial fee was extremely low, and (b) the amount of future services to be provided to the franchisee was minimal, that is, performance by the franchisor is deemed to have taken place.

			or	
3. Cash	$ 5,000		$ 5,000	
Notes Receivable	20,000		15,163	
Discount on Notes Receivable		$ 4,837		
Earned Initial Franchise Fee		5,000		$ 5,000
Unearned Initial Franchise Fee		15,163		15,163

The assumptions underlying this alternative are that (a) the down payment of $5,000 is not refundable and represents a fair measure of services provided to the franchisee at the time the contract is signed, and (b) a significant amount of services is to be performed by the franchisor in future periods.

4. Cash $ 5,000
   Earned Initial Franchise Fee $ 5,000

   This procedure would be consistent with the cash basis of accounting and would be considered appropriate in situations where (a) the initial fee is not refundable, (b) the contract does not call for a substantial amount of future services to the franchisee, and (c) the collection of any part of the notes is so uncertain that recognition of the notes as assets is unwarranted.

5. Cash $ 5,000
   Unearned Initial Franchise Fee $ 5,000

   The assumption underlying this procedure is that either the down payment is refundable, or substantial services must be performed by the franchisor before the fee can be considered earned. As in alternative 4, the collection of any portion of the notes receivable is so uncertain that recognition in the accounts cannot be considered appropriate.

6. Three additional alternatives would parallel the first three alternatives given above, except that the notes would be reported at their face value. These alternatives would be appropriate in situations where the notes bear interest or call for the payment of interest at the going rate.

b. Because the initial cash collection of $5,000 must be refunded if the franchisee fails to open, it is not fully earned until the franchisee begins operations so that Southern Fried Shrimp should record the initial franchise fee as follows:

			or	
Cash	$ 5,000		$ 5,000	
Notes Receivable	20,000		15,163	
Discount on Notes Receivable		$ 4,837		
Unearned Initial Franchise Fee				
(or Advances by Franchisees)		20,163		$20,163

When the franchisee begins operations, the $5,000 would be earned and the following entry should be made:

Unearned Initial Franchise Fee	$ 5,000	
Earned Initial Franchise Fee		$ 5,000

If there is no time lag between the collection of the $5,000, the performance of the related services and the opening by the franchisee, then the initial cash collection of $5,000 is earned when it is received so the initial franchise fee should be recorded as follows:

			or	
Cash	$ 5,000		$ 5,000	
Notes Receivable	20,000		15,163	
Discount on Notes Receivable		$ 4,837		
Unearned Initial Franchise Fee				
(or Advances by Franchisees)		15,163		$15,163
Earned Initial Franchise Fee		5,000		5,000

After Southern Fried Shrimp has experienced the opening of a large number of franchises, it should be possible to develop probability measures so that the expected value of the retained initial franchise fee can be determined and recorded as earned at the time of receipt.

The notes receivable are properly recorded at their present value. No more than \$15,163, the net present value of the notes, should be reported as an asset. Interest at 10% should be accrued each year by a debit to Discount on Notes Receivable (or Notes Receivable) and a credit to Interest Revenue. Collections are recorded as debits to Cash and credits to Notes Receivable. Each year as the services are rendered an appropriate amount would be transferred from Unearned Initial Franchise Fee to Earned Initial Franchise Fee. Since these annual payments are not refundable, the Earned Initial Franchise Fee revenue might be recognized at the time the \$4,000 is collected, but this may result in the mismatching of cost and revenue.

At the time that a franchisee opens, only two steps remain before Southern Fried Shrimp will have fully earned the entire franchise fee. First, it must provide expert advice over the five-year period. Second, it must wait until the end of each of the next five years so that it may collect each of the \$4,000 notes. Since collection has not been a problem, and since the advice may consist largely of manuals and periodical service tip fliers, it could be maintained that a substantial portion of the \$15,163, the present value of the notes, should be recognized as revenue when a franchisee begins operations. Although there have been no defaults on the notes, the extent of Southern Fried Shrimp's experience may be so limited that there may in fact be a substantial collection problem in the future (as has been the actual experience of many franchisors in the recent past). At some time in the future, after Southern Fried Shrimp has experienced a large number of franchises that have opened and operated for five years or more, it should be possible to develop probability measures so that the earned portion of the present value of the notes may be recognized as revenue at the time the franchisee begins operations.

The monthly fee of 2% of sales should be recorded as revenue at the end of each month. This fee is for current services rendered and should be recognized as the services are performed.

c. If the rental portion of the initial franchise fee, \$10,000, represents the present value of monthly rentals over a ten-year period, it should be recorded as Unearned Lease Revenue to be recognized on an actuarially sound basis over the periods benefiting from the use of the leased assets. This type of transaction does not necessarily represent a sale of the equipment and immediate recognition of the entire rental as revenue may not be appropriate.

If the transaction could be considered to be a sale of equipment, the entire rental revenue of \$10,000 should be recognized immediately upon delivery of the equipment.

Since credit risks are no problem, the conditions that must be met to justify recognizing a sale transaction are (1) whether Southern Fried Shrimp retains sizable risks of ownership, and (2) whether there are important uncertainties surrounding the amount of costs yet to be incurred. The fact that no portion of the rental is refundable does not warrant immediate recognition of the entire amount as revenue. The major questions are whether the equipment has a substantial salvage value at the end of the ten years, whether the franchisee or Southern Fried Shrimp gets the equipment free or for a nominal fee at the end of the ten years, and whether Southern Fried Shrimp has responsibility for servicing, repairing and maintaining the equipment during all or part of the ten-year period.

Since the data do not provide answers to these questions, a definitive recommendation can not be given as to the preferable method of accounting for the "rental" portion of the initial franchise fee.

Answer 5

a. 1. Arguments for taxing long-term capital gains at rates lower than those imposed upon ordinary income are:

a. By definition, capital gains are not ordinary gains. Capital gains typically are expected to be realized irregularly. If capital gains were taxed in full at ordinary progressive rates when a transaction occurs, gains accruing over many years would be taxed more heavily in the year of realization than if they had been taxed as they accrued.

b. Long-term capital gains may be largely illusory. The value of a capital asset may increase merely because of general price-level increases. A tax upon the portion of a long-term gain that is attributable to general price-level increases is a tax upon real capital rather than upon a real gain. The same may be true for specific gains (i.e., gains confined to a locality rather than to the general price level) if the holder of the capital asset must replace the asset out of the proceeds from its sale.

c. Any tax upon capital gains tends to discourage new or continued investment in long-term projects. The higher the tax rate the more adverse is the effect. Taxes upon capital gains also withdraw a part of the funds that would otherwise be available for reinvestment.

d. A long holding period tends to discourage the sale of investments because payment of the tax is delayed by not selling the asset. Investments therefore tend to remain in mature companies rather than being made available to new firms which tend to have a higher risk.

2. Arguments against taxing long-term capital gains at rates lower than those imposed upon ordinary income are:

a. Capital gains are just like any other transaction. Many persons and companies regularly have long-term capital gains and consider them as part of their incomes. The gain on an asset held as inventory for a long period of time is taxed as ordinary income while the same type of asset may produce long-term capital gain for an investor. The bunching of income in one year is a problem to be resolved through some type of income-averaging scheme, not through lower taxes on long-term capital gains. Taxpayers regularly count gains on assets held just over six months as long-term capital gains. Such gains do not create bunching problems.

b. The price-level argument is a question of equity in taxation and is not relevant here. Interest on savings accounts and salary increases are taxed even though they may not maintain purchasing power during periods of price-level increases. The price-level argument is an argument for the use of price-level adjusted income for tax reporting, not an argument for lower tax rates on long-term capital gains than the rates imposed upon ordinary income.

c. Any tax reduces the amount of funds left after the tax is imposed; a tax upon a salary reduces the amount a worker has left to save or spend. Therefore, long-term capital gains should not be taxed differently from other kinds of income.

d. The discouraged sales argument is an argument for the annual taxation of any accrued gain, not an argument for a shorter holding period. Besides, investors shift investments to obtain the largest return; they do not retain an investment with a low return merely to avoid a tax levy but rather because they believe that the future return from the present investment will be greater than that from an alternative investment.

b. A special tax should be levied upon tax preference income because that income either escapes tax or causes a smaller tax to be paid. When one taxpayer has tax preference income and another taxpayer does not, the taxpayer not having such income may pay more tax than he would if the preference income were taxed at ordinary income tax rates. This constitutes a higher tax on one taxpayer and a government subsidy to another. In the interest of equity among taxpayers it is desirable that some additional tax should be imposed upon tax preference income.

c. Since noncorporate taxpayers are able to deduct 50% of a long-term capital gain before it is taxed, equity requires the same treatment for a long-term capital loss. If only 50% of a long-term gain is taxed, then only 50% of a long-term loss should be deductible.

Beginning in 1970 the deduction of a long-term capital loss is limited in any one year to 50% of the net long-term capital loss in excess of the net short-term capital gain to a maximum of $1,000. Capital gains and losses must be netted because of the maximum capital loss deduction limitation. This limitation was imposed because a taxpayer may generally select the time when a loss will be recognized for tax purposes by deferring a sale at a loss.

Before such a limitation was imposed, tax revenues tended to decrease substantially when the stock market declined substantially. The desire to stabilize tax revenues in bad years of the stock market is now the chief reason for continuing the limitation since only 50% of a long-term loss is deductible. Previously, taxpayers could time the realization of long-term gains in one year and long-term losses in another year to maximize tax benefits.

Answer 6

a. The basic purpose of financial accounting and financial statements is to provide quantitative financial information about a business enterprise that is useful to statement users, particularly owners and creditors, in making economic decisions. This purpose includes providing information that can be used in evaluating management's effectiveness in fulfilling its stewardship and other managerial responsibilities. Within the framework of these purposes financial accounting and financial statements have a number of objectives that (1) determine the appropriate content of financial accounting information (general objectives), and (2) indicate the qualities that make financial accounting information useful (qualitative objectives). The objectives provide means to evaluate and improve generally accepted accounting principles.

b. 1. The general objectives of financial accounting and statements are:

a. To provide reliable financial information about economic resources and obligations of a business enterprise. This information is important in evaluating the enterprise's strengths and weaknesses. It indicates how enterprise resources are financed and the pattern of its holdings of resources. It aids in evaluating the enterprise's ability to meet its commitments. The information indicates the present resource base available to exploit opportunities and make future progress. In short, information about economic resources and obligations of a business enterprise is needed to form judgments about the ability of the enterprise to survive, to adapt, to grow and to prosper amid changing economic conditions.

b. To provide reliable information about changes in net resources (resources less obligations) of an enterprise that result from its profit-directed activities. Almost all who are directly concerned with the economic activities of an enterprise are interested in its ability to operate successfully. Investors expect a dividend return or increases in the price of ownership shares or both. An enterprise that operates successfully is more likely to be able to pay creditors and suppliers, provide jobs for employees, pay taxes and generate funds for expansion. Management of the enterprise also needs information about economic progress to plan operations and evaluate progress in comparison with previously established goals. To survive, the enterprise needs some minimum level of success in its profit-directed activities over the long run.

c. To provide financial information that assists in estimating the earning potential of the enterprise. Information about the past and present may help users of the information in making predictions. Trend figures usually (though not invariably) are better aids to prediction than the results of a single year. Extrapolations of financial data, however, should be made only in conjunction with the best additional information available about the enterprise, its circumstances and its prospects.

d. To provide other needed information about changes in economic resources and obligations. Examples are information about changes in residual interest from sources other than profit-directed activities and information about working capital or fund flows.

e. To disclose, to the extent possible, other information related to the financial statements that is relevant to statement users' needs. Examples of disclosures of this type are information about the enterprise's accounting policies, such as depreciation and inventory methods, and information about contingent obligations of the enterprise.

The general objectives aid in improving accounting principles by relating the content of the information to the underlying activities of business enterprises and to the interests and needs of users of the information.

The general objectives do not specify which resources and obligations and changes should be measured and reported as assets, liabilities, revenue and expenses in financial accounting. They contain no implication that assets and liabilities ideally should include all resources and obligations or that all changes in assets and liabilities ideally should be reported. Furthermore, they do not specify how the resources and obligations to be recorded should be measured.

2. The qualitative objectives of financial accounting and statements are:

a. Relevance. Relevant financial accounting information bears on the economic decisions for which it is used.

The objective of relevance helps in selecting methods of measuring and reporting in financial accounting that are most likely to aid users in making the types of economic decisions for which they use financial accounting data. In judging relevance of general-purpose information attention is focused on the common needs of users and not on specific needs of particular users. A vital task is to determine these common needs and the information that is relevant to them. Relevance is the primary qualitative objective because information that does not bear on the decisions for which it is used is useless, regardless of the extent to which it satisfies the other objectives.

b. Understandability. Understandable financial accounting information presents data that can be understood by users of the information and is expressed in a form and with terminology adapted to the users' range of understanding.

Understandability is important because accounting information must be intelligible if it is to be useful. Users of financial statements can understand the information only if the data presented and their method of presentation are meaningful to them. Understandability also requires that the users have some understanding of the complex economic activities of enterprises, the financial accounting process and the technical terminology used in financial statements.

c. Verifiability. Verifiable financial accounting information provides results that would be substantially duplicated by independent measurers using the same measurement methods.

Measurements cannot be completely free from subjective opinions and judgments. The process of measuring and presenting information must use human agents and human reasoning and therefore is not founded solely on an "objective reality." Nevertheless, the usefulness of information is enhanced if it is verifiable, that is, if the attribute or attributes selected for measurement and the measurement methods used provide results that can be corroborated by independent measurers.

d. Neutrality. Neutral financial accounting information is directed toward the common needs of users and is independent of presumptions about particular needs and desires of specific users of the information.

Measurements not based on presumptions about the particular needs of specific users enhance the relevance of the information to common needs of users. Preparers of financial accounting information should not try to increase the helpfulness of the information to a few users to the detriment of others who may have opposing interests.

e. Timeliness. Timely financial accounting information is communicated early enough to be used for the economic decisions which it might influence and to avoid delays in making those decisions.

f. Comparability. Comparable financial accounting information presents similarities and differences that arise from basic similarities and differences in the enterprise or enterprises and their transactions and not merely from differences in financial accounting treatments.

Comparability means the ability to bring together for the purpose of noting points of likeness and difference. Comparability of financial information generally depends upon like events being accounted for in the same manner. Comparable financial accounting information facilitates conclusions concerning relative financial strengths and weaknesses and relative success, both between periods for a single enterprise and between two or more enterprises.

g. Completeness. Complete financial accounting information includes all financial accounting data that reasonably fulfill the requirements of the other qualitative objectives.

Financial information that meets the qualitative objectives of financial accounting also meets the reporting standard of adequate disclosure. Adequate disclosure relates particularly to objectives of relevance, neutrality, completeness and understandability. Information should be presented in a way that facilitates understanding and avoids erroneous implications. The headings, captions and amounts must be supplemented by enough additional data so that their meaning is clear but not by so much information that important matters are buried in a mass of trivia.

Answer 7

a. The activity base is direct machine hours. This is a relevant measure of volume since the department produces several products and its principal activity is machine operation. The relevant range should be defined by the low and high volume months; on the basis of the data given, this would be 22,000 to 29,000 direct machine hours. Data on the other months may serve to broaden this range; the volume attained in September suggests that the upper range should be 33,000 or 34,000 direct machine hours.

b. The high-low method requires the initial development of two budget amounts for each cost in the department—based upon expectations—one at the minimum volume and the other at the maximum volume. These two budgets should be developed and the final variable budget approved prior to May 1, 1971 since that was the first date on which it appears to have been needed. Since the variable budget was completed on March 15, 1971, the two initial estimates would have been completed and approved prior to that date. Therefore, prior to that date the manager of Department A should be asked to submit his recommended cost budget for each production cost (1) at 20,000 direct machine hours and (2) at 30,000 direct machine hours. After these two budgets are approved the budget staff would perform the interpolations to derive the fixed and variable components. After final managerial approval the variable budget, as reflected here, would be available for use throughout the coming year. Interpolation to compute the fixed and variable components for indirect wages would be:

Maximum	30,000	$20,100
Minimum	20,000	19,400
Difference	10,000	$ 700

Variable rate = $700 ÷ 10,000 = $.07
Fixed amount = $20,100 — (30,000 × $.07) = $18,000

c. Utilization of the variable budget by date:

1. May 5, 1971 — The cost budget for the department is to be prepared for inclusion in the annual profit plan. The variable budget amount must be applied to the planned level of activity in the department for the year and for each month. The cost budget would be as follows:

Department A—Cost Budget for Annual Profit Plan for Fiscal 1972

	Year	*July*	*August*	*September*	*Etc.*
Planned output in direct machine hours	325,000	22,000	25,000	29,000	249,000
Controllable costs:					
Employee salaries	$108,000	$ 9,000	$ 9,000	$ 9,000	Etc.
Indirect wages	238,750	19,540	19,750	20,030	
Indirect materials	29,250	1,980	2,250	2,610	
Other costs	81,750	6,660	6,750	6,870	
	$457,750	$37,180	$37,750	$38,510	

Computation of indirect wages:
Annual: ($18,000 × 12) + ($.07 × 325,000) = $238,750
July: $18,000 + ($.07 × 22,000) = $ 19,540

2. August 31, 1971 — The budgeted costs for the department manager should be recomputed to reflect the revised output expectations (34,000 direct machine hours) as follows:

Department A — Budget Costs for Work Scheduled for September (34,000 Direct Machine Hours)

Controllable costs:	
Employee salaries	$ 9,000
Indirect wages	20,380
Indirect materials	3,060
Other costs	7,020
	$39,460

3. September 30, 1971 — The September performance report is to be prepared using actual costs in the department and compared with adjusted budget allowances. Thus, the variable budget values must be applied to the actual output attained of 33,000 direct machine hours. The performance report follows:

Department A—Performance Report for September 1971

Controllable Costs	*Actual Incurred at 33,000 Direct Machine Hours*	*Adjusted Budget at 33,000 Direct Machine Hours*	*Variance*
Employee salaries	$ 9,300	$ 9,000	($300)
Indirect wages	20,500	20,310	(190)
Indirect materials	2,850	2,970	120
Other costs	7,510	6,990	(520)
	$40,160	$39,270	($890)

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